(7) (6)

Nos. 94-1893 and 94-1900

In the Supreme Court of the United States

OCTOBER TERM, 1995

Supreme Court, U.S.
FILED
AUG 18 1995
CLERK

UNITED STATES OF AMERICA, ET AL., PETITIONERS

v.

THE CHESAPEAKE AND POTOMAC TELEPHONE COMPANY OF VIRGINIA, ET AL.

NATIONAL CABLE TELEVISION ASSOCIATION, INC., PETITIONER

v.

BELL ATLANTIC CORPORATION, ET AL.

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

JOINT APPENDIX

DREW S. DAYS, III *
Solicitor General
Department of Justice
Washington, D.C. 20530
Counsel for Petitioners in No. 94-1893

H. BARTOW FARR, III *
FARR & TARANTO
2445 M Street, N.W.
Washington, D.C. 20037
Counsel for Petitioners in No. 94-1900

LAURENCE H. TRIBE *
Hauser Hall 420
1575 Massachusetts Ave.
Cambridge, Mass. 02138
Counsel for Respondents

* Counsel of Record

PETITIONS FOR CERTIORARI FILED MAY 18, 1995
CERTIORARI GRANTED JUNE 26, 1995

BEST AVAILABLE COPY

TABLE OF CONTENTS

	Page
Docket entries, United States District Court for the Eastern District of Virginia	1
Complaint (December 17, 1992)	6
Answer of Governmental Defendants (February 12, 1993)	18
Concurring Statement of Commissioner Joseph R. Fogarty, Accompanying FCC Policy on Cable Ownership: A Staff Report (1981)	24
FCC Policy on Cable Ownership: A Staff Report (1981)	31
General Accounting Office, Telephone Communications: Controlling Cross-Subsidy Between Regulated and Competitive Services (October 1987)	79
License Agreement For Pole Attachments And/Or Conduit Occupancy (September 1, 1992)	102
General Accounting Office, Telecommunications: FCC's Oversight Efforts To Control Cross-Subsidization (February 1993)	118
Affidavit of Robert W. Lucky (April 26, 1993)	137
Affidavit of William E. Lee (April 27, 1993)	142
Affidavit of Richard A. Alston (April 27, 1993)	169
Affidavit of Dr. Vivian M. Horner (April 28, 1993)	171
Affidavit of Thomas W. Hazlett (April 29, 1993)	173
Joint Stipulations of Fact (April 30, 1993)	195
Affidavit of Glen O. Robinson (May 19, 1993)	222
Affidavit of Bruce M. Owen (May 20, 1993)	241
Reply Affidavit of Alfred E. Kahn (May 28, 1993)	272
Affidavit of Patricia S. Ticer (June 2, 1993)	282
Affidavit of Jean Pool (June 2, 1993)	284
Affidavit of Robert L. Townsend (June 3, 1993)	286

TABLE OF CONTENTS—Continued

Page

Supplemental Affidavit of William E. Lee (June 3, 1993) 293

Affidavit of H.R. Stallard (June 4, 1993) 299

Affidavit of Robin Smith (June 4, 1993) 322

Reply Affidavit of Bruce M. Owen (June 9, 1993) 331

Excerpts From Principal Government Documents..... 337

Excerpts From Principal Government Documents..... 348

Transcript of District Court Hearing on Motions (June 17, 1993) 361

Transcript of Oral Argument, United States Court of Appeals for the Fourth Circuit (February 7, 1994).. 368

Administration White Paper on Communications Act Reforms (January 1994) 370

Statement of Reed E. Hundt, Chairman of Federal Communications Commission, Before the Subcommittee on Telecommunications and Finance, Committee on Energy and Commerce, United States House of Representatives (January 27, 1994) 375

Statement of Anne K. Bingaman, Assistant Attorney General, Antitrust Division, Before the Subcommittee on Telecommunications and Finance, Committee on Energy and Commerce, United States House of Representatives (January 27, 1994) 380

Testimony of Larry Irving, Assistant Secretary for Communications and Information, U.S. Department of Commerce, on Telecommunications Reform Legislation, Before the Subcommittee on Economic and Commercial Law, Committee on the Judiciary, House of Representatives (January 26, 1994) 382

Testimony of Larry Irving, Assistant Secretary for Communications and Information, U.S. Department of Commerce, on Telecommunications Reform Legislation, Before the Subcommittee on Telecommunications and Finance, Committee on Energy and Commerce, United States House of Representatives (January 27, 1994) 383

TABLE OF CONTENTS—Continued

Page

Order Allowing Certiorari, *United States* v. *Chesapeake and Potomac Telephone Co. of Virginia* (June 26, 1995) 385

Order Allowing Certiorari, *National Cable Television Association v. Bell Atlantic Corporation* (June 26, 1995) 386

NOTICE

The following opinions and order have been omitted in printing this appendix because they appear in the following pages in the printed appendix to the petition for a writ of certiorari in No. 94-1893:

Opinion of the Court of Appeals (November 21, 1994).. 1a

Opinion of the District Court (August 24, 1993) 53a

Order of the Court of Appeals Denying Rehearing (January 18, 1995) 109a

Federal Communications Commission, Fourth Further Notice of Proposed Rulemaking (January 20, 1995).. 113a

The following order has been omitted from this appendix because it appears in the printed appendix to the supplemental brief of petitioners in support of the petition for a writ of certiorari in No. 94-1893:

Federal Communications Commission, Third Report and Order (May 16, 1995) 1a

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF VIRGINIA
(Alexandria Division)

No. 92-CV-1751

THE CHESAPEAKE AND POTOMAC TELEPHONE COMPANY OF VIRGINIA, ET AL., PLAINTIFFS

v.

UNITED STATES OF AMERICA, ET AL., DEFENDANTS

RELEVANT DOCKET ENTRIES

DATE	No.	PROCEEDINGS
12/17/92	1	COMPLAINT Filing Fee $120.00 Receipt #93884 (bonn)
		* * * * *
2/8/93	3	MOTION to Intervene as a deft by Natl Cable TV (bonn) [Entry date 02/09/93]
2/8/93	4	MEMORANDUM by Natl Cable TV in support of [3-1] motion to Intervene as a deft by Natl Cable TV (bonn) [Entry date 02/09/93]
2/8/93	5	ANSWER to Complaint by Natl Cable TV (Attorney, James Saunders), (bonn) [Entry date 02/09/93]
		* * * * *
2/16/93	8	ANSWER to Complaint by William Barr, FCC, United States (Attorney Richard Parker), (bonn) [Entry date 02/18/93]
		* * * * *

DATE	No.	PROCEEDINGS
3/1/93	13	ORDER this matter comes before the court on the motion of the National Cable Television Association, Inc. to intervene as a deft, for the reasons stated from the bench: NCTA's motion to intereven [*sic*] as a right, is denied, NCTA's motion for permissive intervention, is gratned [*sic*] subject to the following conditions (see order for details) the parties are futher [*sic*] directed to submit to the court a mutually agreeable briefing sch. and culminating in oral argument on either 5/13/93, 5/20/93 or 5/27/93 ent - filed (signed by Judge T. S. Ellis III) Copies Mailed: yes (rvoi) [Entry date 03/02/93]
		* * * * *
4/30/93	46	MOTION by Chesapeak [*sic*] & Potomac, Bell Atlantic Video for Summary Judgment (bonn)
4/30/93	47	JOINT stipulation of fact - file by parties. (bonn)
		* * * * *
4/30/93	49	LIST of authenticated documents - filed by parties. (bonn)
4/30/93	50	AFFIDAVITS and Excerpts from principal government documents in support of motion for summary judgment - filed by pltfs. (bonn)
		* * * * *
5/21/93	65	CROSS MOTION by Natl Cable TV for Summary Judgment (bonn) [Entry date 05/24/93]
		* * * * *
5/24/93	67	MOTION by United States, FCC for Summary Judgment (bonn)
		* * * * *

DATE	No.	PROCEEDINGS
6/7/93	77	OBJECTIONS by Bell Atlantic Video, Chesapeak & Potomac to exhibits filed in connection with summary judgment (bonn)
		* * * * *
8/24/93	96	MEMORANDUM OPINION (signed by Judge T. S. Ellis III) Copies Mailed: yes (rvoi) [Edit date 08/24/93]
8/24/93	97	ORDER this matter comes before the court on cross-motions for summary judgment, for the reasons stated in the accompanying memorandum opinion, pltf's motion for summary judgment is gratned, [*sic*] and defts' and intervenor-defts' motion for summary judgment are denied. Defts are hereby enjoined from enforcement of 47 USC 533 entfiled (signed by Judge T. S. Ellis III) Copies Mailed: yes (rvoi)
		* * * * *
9/8/93	99	MOTION for relief from judgment and to alter or amend judgment by United States, FCC, Janet Reno (bonn)
		* * * * *
9/8/93	102	MOTION to intervene by Ameritech Corporation, BellSouth Corporation, GTE Service Corporation, NYNEX Corporation, Pacific Telesis Group, Rochester Telephone Corporation, Southwestern Bell Corporation and US West, Inc. (bonn) [Entry date 09/09/93]
		* * * * *
9/20/93	110	MOTION for joinder of parties as pltfs by Chesapeak & Potomac, Bell Atlantic Video (bonn) [Entry date 09/21/93]
		* * * * *

DATE	No.	PROCEEDINGS
10/7/93	121	ORDER granting [110-1] motion for joinder of parties as pltfs by Chesapeak & Potomac Bell Atlantic Video, granting with respect to specifying that the order dated 9/8/93 applies only to Section 533(b) and not to the entire Section 533 and denying all other aspects of the [99-1] motion for relief from judgment and to alter or amend judgment by United States, FCC, Janet Reno, denying [105-1] motion to intervene by GTE Virginia and GTE Vantage Inc., denying [102-1] motion to intervene by Ameritech Corporation, BellSouth Corporation, GTE Service Corporation, NYNEX Corporation, Pacific Telesis Group, Rochester Telephone Corporation, Southwestern Bell Corporation and US West, Inc. - entered & filed (signed by Judge T. S. Ellis III) Copies Mailed: Yes (bonn)
10/7/93	122	AMENDED FINAL ORDER that the court's memorandum opinion dated 8/24/93, pltfs' motion for summary judgment is granted, and defts' and intervenor-deft's motions for summary judgment are denied. The court declares 47 USC Section 533(b) unconstitutional both on its face and as applied to pltfs. The following parties are joined as pltfs: Bell Atlantic Corporation, The Chesapeake and Potomac Telephone Company. The Chesapeake and Potomac Telephone Company of Maryland, The Chesapeake and Potomac Telephone Company of West Virginia, The Diamond State Telephone Company, New Jersey Bell Telephone Company and the Bell Telephone Company of Pennsylvania. Defts. are hereby enjoined from enforcement of 47 USC Section 533(b) against the above named parties. This order supersedes and

DATE	No.	PROCEEDINGS
		replaces the court's order dated 8/24/93 - entered & filed. (signed by Judge T. S. Ellis III) Copies Mailed: Yes (bonn)
		* * * * *
10/15/93	124	NOTICE OF APPEAL of orders of 10/7/93, and 8/24/93 by Janet Reno, FCC, United States. Copy of notice mailed to all parties. Copy of notice, orders and docket entries mailed to USCA. (bonn) [Entry date 10/18/93]
		* * * * *

[Filed Dec. 17, 1992]

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF VIRGINIA
(Alexandria Division)

Civil Action No. 92-1751-H

THE CHESAPEAKE AND POTOMAC
TELEPHONE COMPANY OF VIRGINIA,
600 East Main Street
Richmond, Virginia 23219

and

BELL ATLANTIC VIDEO SERVICES COMPANY,
1320 N. Court House Road
Arlington, Virginia 22201

PLAINTIFFS

v.

UNITED STATES OF AMERICA,

FEDERAL COMMUNICATIONS COMMISSION,
1919 M Street, N.W.
Washington, D.C. 20554

and

WILLIAM P. BARR, in his official capacity as
Attorney General of the United States of America,
Department of Justice
10th & Constitution Ave., N.W.
Washington, D.C. 20530

DEFENDANTS

For All Defendents, Serve:

Richard Cullen
United States Attorney for the
Eastern District of Virginia
1101 King Street, Suite 502
Alexandria, Virginia 22314

COMPLAINT FOR DECLARATORY JUDGMENT AND INJUNCTIVE RELIEF

1. The Cable Communications Policy Act of 1984, 47 U.S.C. § 533(b) ("Cable Act"), prohibits The Chesapeake & Potomac Telephone Company of Virginia and its affiliate, Bell Atlanic Video Services Company, from providing video programming—including television shows, movies, sports, news, and political reporting and opinions —to subscribers in C&P's telephone service area. This is an action pursuant to 28 U.S.C. §§ 2201 and 2202 to declare this prohibition unconstitutional and to enjoin the defendants from enforcing it. The government defendants, who bear the burden of justifying this prohibition, have stated that the prohibition is not necessary to serve any valid governmental purpose and that it should be repealed. Congress, however, has failed to repeal the prohibition, and the defendants have indicated that they will continue to enforce it.

JURISDICTION AND VENUE

2. This Court has subject matter jurisdiction of this controversy under 28 U.S.C. § 1331.

3. Venue is proper in this judicial district pursuant to 28 U.S.C. § 1391(e).

PARTIES

4. Plaintiff The Chesapeake and Potomac Telephone Company of Virginia ("C&P") is a corporation incorporated under the laws of the Commonwealth of Virginia

and is a wholly-owned subsidiary of Bell Atlantic Corporation, a publicly held company with over one million shareowners. C&P is in the business of providing telephone service in, among other places, the City of Alexandria, Virginia, and is a "common carrier" within the meaning of section 533(b) of the Cable Act.

5. Plaintiff Bell Atlantic Video Services Company ("BVS") is a corporation incorporated under the laws of the Commonwealth of Virginia and is a wholly-owned subsidiary of Bell Atlantic Corporation. BVS was incorporated for the purpose of providing video programming in, among other places, the City of Alexandria and is affiliated with C&P within the meaning of section 533(b) of the Cable Act.

6. Defendant United States of America is a party to this action.

7. Defendant Federal Communications Commission ("FCC") is a federal agency created by Congress pursuant to the Communications Act of 1934 (47 U.S.C. §§ 151 *et seq.*) and is charged with enforcement of section 533(b) and other regulation of cable television pursuant to 47 U.S.C. §§ 401 and 521 *et seq.*

8. Defendant William P. Barr, named in his official capacity as Attorney General of the United States of America, is charged with enforcement of section 533(b) pursuant to 47 U.S.C. § 401.

Background

9. In 1984, Congress passed the Cable Communications Policy Act, 47 U.S.C. §§ 521 *et seq.* ("Cable Act"), which among other things prohibits telephone companies and their affiliates from providing video programming within the areas where they provide telephone service. Section 533(b) of the Cable Act provides in relevant part as follows:

> (b)(1) It shall be unlawful for any common carrier, subject in whole or in part to subchapter II of

this chapter, to provide video programming directly to subscribers in its telephone service area, either directly or indirectly through an affiliate owned by, operated by, controlled by, or under common control with the common carrier.

(2) It shall be unlawful for any common carrier, subject in whole or in part to subchapter II of this chapter, to provide channels of communications or pole line conduit space, or other rental arrangements, to any entity which is directly or indirectly owned by, operated by, controlled by, or under common control with such common carrier, if such facilities or arrangement are to be used for, or in connection with, the provision of video programming directly to subscribers in the telephone service area of the common carrier.

10. The Cable Act defines "video programming" as "programming provided by, or generally considered comparable to programming provided by, a television broadcast station." 47 U.S.C. § 522(16).

11. Under section 533(b), it is unlawful for C&P and BVS, as affiliates, to provide video programming directly to subscribers in areas where C&P provides telephone service. It is also unlawful for C&P to provide channels of communications to BVS for use in provision of video programming in these areas.

COUNT I

SECTION 533(b) IS UNCONSTITUTIONAL ON ITS FACE UNDER THE FIRST AMENDMENT

12. The allegations of paragraphs 1 through 11 are incorporated herein by reference.

13. Video programming is a form of speech protected by the First Amendment of the United States Constitution. Video programmers own, produce, select, assemble,

package, and distribute images, ideas, information, opinions, and entertainment.

14. The video programming prohibition in section 533(b) of the Cable Act is, on its face, an unconstitutional prior restraint on speech.

15. The prohibition is, on its face, a straightforward ban on certain types of constitutionally protected expression. The prohibition is directed at speech itself and therefore requires strict scrutiny.

16. Under the statutory definition of "video programming," 47 U.S.C. § 522(16), the applicability of the restriction necessarily turns on the content of telephone companies' speech. Congress has required government officials to decide whether telephone companies are providing prohibited speech that is "generally considered comparable to" television broadcast programming or whether they are providing non-prohibited speech which may also involve video images. This statutorily required process of official authorization, therefore, involves an evaluation of the video images and the context in which they are to be presented; a consideration of the impact such video images will have upon the viewer; and a determination whether such video images will be perceived by the general public as a substitute for the forms of video speech that have been provided by others over traditional cable and broadcasting facilities. All of the foregoing involves the government in an investigation of content. Consequently, the statutory prohibition is content-based and must be subject to strict scrutiny.

17. Section 533(b) is a speaker-specific restriction on protected expression that singles out speech provided by telephone companies and imposes a special and targeted prohibition on that speech in particular. Strict scrutiny is therefore warranted.

18. Section 533(b) is an audience-specific restriction on protected expression that prevents telephone companies from providing video programming only to subscribers

within their telephone service areas. Strict scrutiny is therefore warranted.

19. Section 533(b) violates both the First Amendment right of telephone companies to provide video programming and the First Amendment right of subscribers to receive the video programming which plaintiffs and other telephone companies would provide.

20. The government defendants, which bear the burden of justifying this infringement of First Amendment rights, cannot prove that section 533(b) is necessary to serve any compelling governmental interest or even any substantial or important governmental interest.

21. The speech targeted by section 533(b)—television shows, movies, sports, news, and political reporting and opinions—is not unlawful.

22. In enacting section 533(b) in 1984, Congress stated that it was seeking to prevent the development of "local media monopolies." This objective has not been achieved. In 1992, in enacting the Cable Television Consumer Protection and Competition Act, Congress found that "[t]he cable industry has become highly concentrated. The potential effects of such concentration are barriers to entry for new programmers and a reduction in the number of media voices available to consumers." Congress found that "[t]he average monthly cable rate has increased almost 3 times as much as the Consumer Price Index" since 1986. "[M]ost cable television subscribers have no opportunity to select between competing cable systems. Without the presence of another multichannel video programming distributor, a cable system faces no local competition. The result is undue market power for the cable operator . . . ."

23. The government defendants themselves have found that section 533(b) is now hindering the objectives it was originally intended to promote:

a. In 1988, defendant FCC tentatively concluded that the prohibition "no longer serves the public interest." In

1992, on a full administrative record, the FCC found that the prohibition should be repealed. Repealing the prohibition would "increas[e] competition in the video marketplace, spur[] the investment necessary to deploy an advanced infrastructure, and increas[e] the diversity of services made available to the public." Separately, the FCC reported to the President that introducing competition from telephone companies "would result in significant price savings for consumers and stimulate provision of a range of new information services. Current experience with head-to-head competition in cable markets indicates that rates would fall about 20% for the entire video package; if competition is introduced nationwide, subscribership would likely expand by 11.2 million households."

b. Defendant Barr in his official capacity as Attorney General stated that "[t]elevision viewers will be best served by removing barriers to entry by new firms into the video services marketplace. The Administration, therefore, supports removal of current legislative prohibitions against telephone company provision of video programming, with appropriate safeguards." The Department of Justice, acting under the supervision of defendant Barr, stated that telephone companies "should be allowed to own and directly provide video programming" because telephone company "provision of video programming will have procompetitive benefits that outweigh any anticompetitive risks involved."

24. The defendants to this action further have concluded that any valid governmental concerns can be addressed by means that do not prohibit telephone companies and their affiliates from video programming.

25. Despite their concessions that the video programming prohibition is not necessary to any governmental interest, defendants have indicated that they will continue to enforce the prohibition. Consequently, there is an actual and justiciable controversy between the parties.

26. Plaintiffs, as well as consumers who are being denied the right to receive video programming which plaintiffs and other telephone companies would provide, have no adequate or complete remedy at law to redress the denial of their First Amendment rights other than by seeking the relief sought in this action. Unless defendants are enjoined from enforcing section 533(b), plaintiffs and consumers will continue to suffer substantial and irreparable harm.

COUNT II

SECTION 533(b) IS UNCONSTITUTIONAL AS APPLIED UNDER THE FIRST AMENDMENT

27. The allegation of paragraphs 1 through 26 are incorporated herein by reference.

28. If permitted to proceed, C&P and BVS will provide video programming in the City of Alexandria, Virginia. C&P will enhance its telephone network in Alexandria to have the capability of carrying several hundred channels of video programming. In addition, C&P's network will have the capability to deliver video programs on demand, which will allow consumers to select programs from video libraries. C&P's affiliate, BVS, will provide some of the video programming on the network, and the network will also be available for use by other video programmers on a common carrier basis.

29. Plaintiffs are ready, willing and, but for defendants' enforcement of section 533(b), able to provide video programming to Alexandria. Consumers in Alexandria want to receive this programming. As a result of the defendants' continued enforcement of section 533(b), both plaintiffs and consumers will continue to suffer substantial and irreparable harm. Plaintiffs have no adequate or complete remedy at law to redress the denial of First Amendment rights other than by seeking the relief sought in this action.

30. Although section 533(b)(4) of the Cable Act provides that the FCC may in particular circumstances waive

the video programming prohibition for "good cause," this waiver provision is inadequate to protect the plaintiffs' and consumers' right to free speech and is itself a violation of the First Amendment. Congress provided no standards or time limits by which the FCC must grant or deny a "good cause" waiver, but instead admonished the FCC that this "waiver authority should be narrowly construed." The FCC itself has not adopted any standards or time limits. As a result, the FCC has unbridled discretion in determining whether and when, if ever, a "good cause" waiver may be granted.

31. As applied to the facts and circumstances of the video programming services that plaintiffs would provide in Alexandria, section 533(b) violates plaintiffs' right of free speech under the First Amendment, as well as the First Amendment right of consumers in Alexandria to receive plaintiffs' video programming.

COUNT III

SECTION 533(b) VIOLATES EQUAL PROTECTION BOTH ON ITS FACE AND AS APPLIED

32. The allegations of paragraphs 1 through 31 are incorporated herein by reference.

33. Section 533(b) is a legislative classification that interferes with the plaintiffs' exercise of the fundamental right of freedom of speech. Section 533(b) discriminates against telephone companies that wish to provide video programming while permitting other, similarly situated entities to engage in this activity.

34. Section 533(b) does not apply at all to other regulated utility companies, including utilities owning poles and conduits, that are permitted to provide video programming in their service areas.

35. Section 533(b) also does not apply to the cable TV companies which Congress found have "undue market power." As interpreted by the FCC, section 533(b)

applies only in one direction: against telephone companies that seek to provide video programming, and not against cable TV companies that seek to provide telephone service. Cable TV companies and their affiliates are taking advantage of this one-sided prohibition by providing long distance telephone services, cellular radio services, personal communications services, competitive access services, and other telephone services in the same areas where they provide video programming.

36. Section 533(b)'s discrimination against telephone companies is not necessary to serve any compelling governmental interest.

37. Section 533(b) violates the equal protection principles embodied in the Fifth Amendment to the United States Constitution, both on its face and as applied to the video programming that plaintiffs would provide in Alexandria.

38. Plaintiffs have no adequate or complete remedy at law to redress the denial of their Fifth Amendment rights other than by seeking the relief sought in this action. Unless the defendants are enjoined from enforcing section 533(b), plaintiffs will continue to suffer substantial and irreparable harm.

COUNT IV

SECTION 533(b) VIOLATES PLAINTIFFS' RIGHTS TO USE THEIR PROPERTY FOR EXPRESSION

39. The allegations of paragraphs 1 through 38 are incorporated herein by reference.

40. Plaintiffs propose to use the existing C&P telephone network, together with certain enhancements, to provide video programming in Alexandria.

41. Section 533(b) violates the rights of plaintiffs to harness their property's potential for constitutionally protected expression, in violation of both the First and Fifth Amendments.

PRAYER FOR RELIEF

WHEREFORE, plaintiffs pray that the Court enter an Order:

1. Declaring that section 533(b) of the Cable Act is unconstitutional, void, and unenforceable on its face as a violation of the right to free speech guaranteed by the First Amendment to the United States Constitution;

2. Declaring that section 533(b) of the Cable Act is unconstitutional, void, and unenforceable under the First Amendment to the United States Constitution as applied to plaintiffs' provision of video programming in Alexandria;

3. Declaring that section 533(b) of the Cable Act is unconstitutional, void, and unenforceable as a violation of the right to the equal protection of the laws under the Fifth Amendment to the United States Constitution;

4. Declaring that section 533(b) of the Cable Act is unconstitutional, void, and unenforceable under the First and Fifth Amendments to the United States Constitution as a violation of plaintiffs' rights to use their propery for expression;

5. Permanently enjoining defendants from enforcing section 533(b) of the Cable Act in any criminal, civil, or administrative proceedings; and

6. Granting plaintiffs such further relief as the Court may deem just and equitable.

THE CHESAPEAKE AND POTOMAC TELEPHONE COMPANY OF VIRGINIA and BELL ATLANTIC VIDEO SERVICES COMPANY, By Counsel

/s/ Wiley R. Wright, Jr.
WILEY R. WRIGHT, JR.
VSB #1006
HAZEL & THOMAS, P.C.
510 King Street, Suite 200
Alexandria, Virginia 22314
(703) 836-8400

LAURENCE H. TRIBE
JONATHAN MASSEY
1525 Massachusetts Avenue
Cambridge, Mass. 02138
(617) 495-4621

ROBERT A. LEVETOWN
VSB #23654
1310 N. Court House Road
11th Floor
Arlington, Virginia 22201
(703) 974-3624

MARK C. HANSEN
JOHNSON & GIBBS
1301 K Street, N.W.
Suite 800 East
Washington, D.C. 20005
(202) 682-4532

JOHN THORNE
MICHAEL E. GLOVER
VSB #25033
1710 H Street, N.W.
Washington, D.C. 20006
(202) 392-0895

WARNER F. BRUNDAGE, JR.
VSB #16281
600 East Main Street
24th Floor
Richmond, Virginia 23261
(804) 772-1585

Dated: December 17, 1992

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF VIRGINIA

(Caption Omitted in Printing)

ANSWER

Defendants United States of America, the Federal Communications Commission (the "FCC," or "Commission") and Stuart M. Gerson, in his capacity as Interim Acting Attorney General,[1] answer plaintiffs' Complaint for Declaratory Judgment and Injunctive Relief, dated December 17, 1992 (the "Complaint"), as follows:

First Defense

Plaintiffs lack standing to sue.

Second Defense

The Court lacks jurisdiction over Count IV of the Complaint.

Third Defense

Plaintiffs have failed to exhaust their administrative remedies.

Fourth Defense

The Complaint fails to state claims for which relief can be granted.

Fifth Defense

The relief sought by plaintiffs is not authorized by law.

---

[1] Pursuant to Rule 25(d)(1) of the Federal Rules of Civil Procedure, Mr. Gerson, in his official capacity as Interim Acting Attorney General, is automatically substituted as a defendant herein for William P. Barr.

Sixth Defense

The equitable relief sought by plaintiffs is barred because they have an adequate remedy at law.

Seventh Defense

Defendants respond to the numbered paragraphs in the Complaint as follows:

1. The first sentence of paragraph one states a conclusion of law to which no response is required. Sentence two contains plaintiffs' characterization of this action, to which no response is required. As to sentence three, deny that defendants have stated that 47 U.S.C. § 533(b) ("Section 533(b)") does not "serve any valid governmental purpose"; the remainder of sentence three purports to characterize *Television Company-Cable Television Cross-Ownership Rules: Second Report and Order, Recommendation to Congress, and Second Further Notice of Proposed Rulemaking*, 7 FCC Rcd. 5781 (1992) (the *"Second Report and Order"*), the April 1, 1992 letter from former Attorney General William P. Barr, and former Commerce Secretary Barbara H. Franklin, to Hon. Edward J. Markey, Chairman, Subcommittee on Telecommunications and Finance, House Committee on Energy and Commerce (the "Markey letter"), and *Telephone Company-Cable Television Cross-Ownership Rules: Reply Comments of the United States Department of Justice*, dated March 13, 1992 (the *"Justice Reply Comments"*), to all of which this Court is respectfully referred for a full and accurate statement of their contents. Admit sentence four.

2-3. Admit.

4. Defendants lack sufficient information or knowledge to form a belief as to the truth or falsity of the first sentence of paragraph four. Admit the second sentence.

5. Defendants lack sufficient information or knowledge to form a belief as to the truth or falsity of paragraph five.

6. Admit.

7. Admit that the Commission is an agency of the Federal Government created by 47 U.S.C. § 154, and is charged by the Communications Act of 1934, 47 U.S.C. § 151 *et seq.*, with the enforcement of Section 533(b).

8. Admit that the Attorney General of the United States is charged with the enforcement of Section 533(b) pursuant to 47 U.S.C. § 401 and other statutory provisions.

9. As to sentence one, admit that in 1984 Congress passed the Cable Communications Policy Act, 47 U.S.C. § 521 *et seq.* The remainder of sentence one states a conclusion of law to which no response is required. Sentence two purports to set out the provisions of Section 533(b)(1) and (b)(2), to which the Court is respectfully referred for a full and accurate statement of its contents.

10. Paragraph 10 purports to set out the provisions of 47 U.S.C. § 522(16), to which the Court is respectfully referred for a full and accurate statement of its contents.

11. Paragraph 11 states conclusions of law to which no response is required.

12. Defendants incorporate herein by reference their responses to paragraphs 1-11 of the Complaint.

13. Sentence one states a conclusion of law to which no response is required. Plaintiffs' use of the term "video programmers" is too vague and ambiguous for defendants to form a belief as to the truth or falsity of sentence two.

14-21. Paragraph 14-21 state conclusions of law to which no response is required.

22. Sentence one purports to characterize H.R. Rep. No. 549, 95th Cong., 2d Sess. (1984), *reprinted in* 1984 U.S. Code Cong. & Admin. News ("U.S.C.C.A.N.") 4655, to which the Court is respectfully referred for a full and accurate statement of its contents. Deny sentence two. Sentences 3-8 purport to characterize the Cable Television Consumer Protection and Competition Act of 1992, P.L. 102-385, 106 Stat. 1460 (the "1992 Act"), § 2, to which

Act the Court is respectfully referred for a full and accurate statement of its contents.

23. Deny sentence one. As to paragraph 23(a): Sentence one purports to characterize the Commission's tentative decision in *Television Company-Cable Television Cross-Ownership Rules: Further Notice of Inquiry and Notice of Proposed Rulemaking*, 3 FCC Rcd. 5849 (1988), to which the Court is respectfully referred for a full and accurate statement of its contents. Sentences two and three purport to characterize the Commission's *Second Report and Order* (*see* ¶ 1, above), to which the Court is respectfully referred for a full and accurate statement of its contents. Sentences four and five purport to characterize the Report of the Federal Communications Commission Regarding the President's Regulatory Reform Program, dated April 28, 1992, to which the Court is respectfully referred for a full and accurate statement of its contents.

As to paragraph 23(b): Sentences one and two purport to characterize the Markey letter (*see* ¶ 1, above), to which the Court is respectfully referred for a full and accurate statement of its contents. Sentence three purports to characterize the *Justice Reply Comments* (*see id.*), to which the Court is respectfully referred for a full and accurate statement of its contents.

24. Paragraph 24 purports to characterize the Commission's *Second Report and Order* and the *Justice Reply Comments*, to which the Court is respectfully referred for a full and accurate statement of their contents.

25. As to the first sentence, admit that defendants will continue to enforce Section 533(b); otherwise, deny. The second sentence states a conclusion of law to which no response is required.

26. Paragraph 26 states conclusions of law to which no response is required.

27. Defendants incorporate herein by reference their responses to paragraphs 1-26 of the Complaint.

28. Defendants lack sufficient information or knowledge to form a belief as to the truth or falsity of paragraph 28.

29. To the extent the first sentence of paragraph 29 is intended as a statement of fact, defendants lack sufficient information or knowledge to form a belief as to its truth or falsity. To the extent it is intended to state a conclusion of law, no response is required. Defendants lack sufficient information or knowledge to form a belief as to the truth or falsity of sentence two. Sentences three and four state conclusions of law to which no response is required.

30. Sentences one and two of paragraph 30 state conclusions of law to which no response is required. Deny sentence three. Sentence four states a conclusion of law to which no response is required.

31. Paragraph 31 states a conclusion of law to which no response is required.

32. Defendants incorporate herein by reference their responses to paragraphs 1-31 of the Complaint.

33-34. Paragraphs 33-34 state conclusions of law to which no response is required.

35. Sentence one states a conclusion of law, to which no response is required, and also purports to characterize the 1992 Act, § 2, to which the Court is respectfully referred for a full and accurate statement of its contents. Sentence two states a conclusion of law to which no response is required. Plaintiffs' use of the term "[c]able TV companies and their affiliates" is too vague and ambiguous for defendants to form a belief as to the truth or falsity of sentence three.

36-38. Paragraphs 36-38 state conclusions of law to which no response is required.

39. Defendants incorporate herein by reference their responses to paragraphs 1-38 of the Complaint.

40. Defendants lack sufficient information or knowledge to form a belief as to the truth or falsity of paragraph 40.

41. Paragraph 41 states a conclusion of law to which no response is required.

The remainder of the Complaint is plaintiffs' prayer for relief, to which no response is required, but to the extent a response is deemed necessary, defendants deny that plaintiffs are entitled to the relief requested therein, or to any relief whatsoever.

Defendants specifically deny any and all allegations of plaintiffs' Complaint not otherwise answered herein.

WHEREFORE, having fully responded to the Complaint, defendants pray that this action be dismissed and that the Court grant such other and further relief as may be appropriate.

Dated: February 12, 1993

Respectfully submitted,

STUART M. GERSON
Assistant Attorney General

RICHARD CULLEN
United States Attorney

RICHARD PARKER
Assistant U.S. Attorney

/s/ James J. Gilligan
THEODORE C. HIRT
JAMES J. GILLIGAN
Attorneys
U.S. Department of Justice
Civil Division, Room 816
901 E Street, N.W.
Washington, D.C. 20004
(202) 514-3358
Counsel for Defendants United States of America, Federal Communications Commission, and Stuart M. Gerson in his official capacity as Interim Acting Attorney General

Of Counsel:

RENEE LIGHT
Acting General Counsel

SUE ANN KANTER
Office of the General Counsel

DONNA LAMPERT
Of Counsel

Federal Communications Commission
1919 M Street, N.W.
Washington, D.C. 20554

FCC POLICY ON CABLE OWNERSHIP: A STAFF REPORT

CONCURRING STATEMENT

of

COMMISSIONER JOSEPH R. FOGARTY

In Re: Issuance for Public Comment of FCC Staff Report on Cable Cross-Ownership Policies

I concur in the Commisison's decision ordering that the Report of the FCC Office of Plans and Policy staff on cable cross-ownership policies be issued for public comment. It should be emphasized, however, that the staff report is just that—a *staff* report—and at this point does not enjoy Commission approval.

In my view, the staff report presents a decidedly mixed bag of policy assessment and pronouncement. I have the same fundamental difficulty with this report that I had with its predecessor on Direct Broadcast Satellite policy: [1] proposed finding of abundant program diversity and assumptions of "workably competitive" markets in video technology and services must be supported by pragmatic fact as well as general economic theory. In finding that a "workably competitive" video media market now exists, the staff report's analysis lumps existing broadcast outlets and cable systems together with subscription television (STV), muti-point distribution systems (MDS), direct broadcast satellites (DBS), low power television, VHF drop-ins, video cassettes and video discs. It is far from clear, however, that cable television service is interchangeable with over-the-air broadcast television service. This substitutability issue is critical to the validity of the

---

[1] *Notice of Inquiry into the Development of Regulation Policy in regard to Direct Broadcast Satellites for the Period following the 1983 Regional Administrative Radio Conference*, Docket 80-603, 45 F.R. 72719 (November 3, 1980), Separate Statement of Commissioner Joseph R. Fogarty.

staff report's policy recommendations and warrants full public comment. It also appear to me to be little more than wishful thinking to predicate a finding of "workable competition" on new technology and services (e.g., DBS, Low Power TV, and fledgling STV and MDS) which are more on the horizon than with us here and now. In the final analysis, this Commisison must have more than merely the *assumption* of a "workably competitive" marketplace as the basis for policy making.

In addressing the specific issues of broadcast television station-and network-cable cross-ownership, the staff report does make certain observations which deserve serious consideration. The report may be correct when it suggests that such cross-ownership may in fact *increase* diversity in both economic and First Amendment terms. In this regard, I agree that while a cable system could control a substantial share of the total video outlets in a community, the relevant policy question is not "How would a cross-owned system behave," but "Would its performance or that of the co-owned broadcast station deteriorate under cross-ownership?" It may be, as the staff report suggests, that natural profit-making and investment incentives, as well as oversight and pressure from the local franchising authority, make it unlikely that cross-owned systems would be any less dedicated to the fullest possible development of cable's potential.

I also think that the staff report is excellent in its discussion of the benefits of vertical integration which may be lost to consumers as a result of overly-restrictive Commission ownership rule and policy.[2] The price to be

---

[2] While it is refreshing to see this acknowledgment of the benefits of vertical integration in the context of an assessment of cable ownership policies, it is regretable that this sensitivity has not been more manifest in other areas of Commission "deregulatory" endeavor. *See Computer Inquiry II, Final Decision*, Statement of Commissioner Joseph R. Fogarty, Dissenting in Part, 77 FCC 2d 504, 508-511 (1980). The degree of structural separation prescribed by the *Final Decision* for the dominant carrier subsidiary's pro-

paid for a reflexive anti-cross-ownership policy may be not only diminished diversity but no service at all.[3] In the final analysis, it is the result, and not the theory, that counts.

While the staff report purports to be responsive to these pragmatic principles in its recommendations regarding broadcast television station-and network-cable cross-ownership, it unfortunately balks at the consistent application of those principles to the telephone company-cable cross-ownership issue. Although the report acknowledges that considerable benefits of vertical integration would inhere in such cross-ownership, it nonetheless argues for retention of the existing prohibition based on the assumption that cable may become a direct competitor of the telephone company's local loop and local exchange services. While the report concedes that this competitive scenario is speculative, it insists that rescission of the cross-ownership prohibition would be "irreversible" in terms of forfeiting whatever benefits of inter-modal com-

---

vision of customer premises equipment and enhanced services reflected an analysis in which

> "all assumptions pertaining to the benefits of separation are treated as givens whereas any countervailing arguments pertaining to the benefits of vertical integration are treated as unproven hypotheses subject to considerable doubt."

Id. at 508.

[3] This observation has proved all too true with regard to the impact of the cable-telephone company cross-ownership prohibition on the provision of cable service to rural America. While the Commission has now adopted an outright exemption from the cross-ownership ban for telephone company rural cable service, *Elimination of the Telephone Company Cable Television Cross-Ownership Rules for Rural Areas*, —— FCC 2d —— (Adopted Nov. 5, 1981), cable service that could have been provided to rural America by telephone companies was long denied in favor of protecting a vague future possibility of service from independent operators. *See, id.*, Separate Statement of Commissioner Joseph R. Fogarty and other Statements cited at n. 1 *supra*.

petition might occur as a result of future independent cable system development.

I have previously stated my opposition to the telephone company-cable cross-ownership prohibition [4] and will not repeat those views in full detail here. However, I think the line of argument in the staff report borders on hallucination. It is inanely wishful thinking to suggest that in the foreseeable future independent cable system operators will install the switching equipment and capacity necessary to duplicate and compete with the local telephone exchange. In terms of either economics or technological demand and investment, the staff report's scenario is sheer fantasy.

The staff report's "irreversibility" argument is even more troublesome for sound analysis and policy. The decision which will be "irreversible" here—and perniciously so—is the one recommended by the staff: the continued and perhaps permanent foreclosure of telephone company participation and competition in the broadband telecommunications marketplace. Indeed, continuation of the prohibition on telephone company-cable cross-ownership will seriously retard, if not completely preclude, the introduction and deployment of broadband, fiber-optic technology in the local telephone exchange. It will be the American consumer who will suffer the loss of telecommunications benefits directly attributable to this myopic policy recommendation.

New and evolving fiber optic telecommunications technology offers the potential for economic replacement of copper wire with glass fiber as the transmission medium in the local loop of the telephone exchange. This potential is enhanced as research and development continues to lower both the cost and signal attenuation of fiber

---

[4] *Revision of Processing Policies for Waivers of Telephone Company—Cable Television "Cross Ownership," On Reconsideration*, Separate Statement of Commissioner Joseph R. Fogarty, 82 FCC 2d 266 (1980).

optics. The ability of fiber optic cables to handle wide-band signals has made fiber optics an ideal transmission medium for high capacity digital data links. This capacity for wide-band signals is certain to be highly useful in other telecommunications applications.

As we enter the Information Age, the need to move large amounts of data among geographically disparate points becomes imperative and acute. Our consumption of wide-band information in the diverse forms of audio, video, and data signals will grow dramatically. It is technically feasible for a single optical fiber to replace the existing network of coaxial cable and copper wire pairs, not only providing telephone and video service to homes but also the delivery path for many additional services. This Commission may not be able to "foster" the obvious public interest benefits of fiber optic technology, but we should certainly recognize an obligation not to get in the way. As I observed in an earlier separate statement on telephone company-cable cross-ownership:

> [T]he Commission must . . . confront the possibility that the prospect of merging fiber optic technology with the local loop of the telephone exchange may offer "natural monopoly" economies in the provision of broadband facilities and services which a sound and rational policy analysis cannot ignore. If these economies emerge in significant magnitude, then telephone company competition in the cable television marketplace may be "unfair" only in the sense that it may be inherently unbeatable. If this should prove to be the case, the hard but necessary answer may have to be that the public interest is better served by such unfairness.*

I find it depressing that the staff report fails to deal seriously and rationally with this critical issue of tech-

---

* 49 FCC 2d 966, 973.

nological and competitive foreclosure. While other countries have been experimenting successfully with optical fiber home connection,[6] there is no apparent active interest in applying fiber technology to the local loop in the United States. Given the constraints and disincentives embodied in the Commission's cross-ownership rules, it is not surprising that despite their service, technological, and investment capabilities, U.S. telephone companies have been reluctant to engage in substantial fiber optic research and development for the local loop. What is surprising—and also reprehensible—is that the agency of the U.S. Government charged with telecommunications oversight should be the perpetrator of this comparative disadvantage to the detriment of our national public interest.

The staff report purports to cope with this regulatory insanity by recommending that the Commission look with favor on telephone company waiver applications propos-

---

[6] In 1978 the first visual information system employing fiber optic technology was completed in Japan. The Japanese system offers 158 subscribers a number of video signals, still pictures, and textual material and demonstrates the feasibility and practicability of using fiber optic technology in the field. HI-OVIS Project Interim Report-Hardware/Software Experiments, July 78-March 79, VISDA MITI Juridical Foundation, Tokyo, Japan, September 1979. In the same year, 1978, Bell Canada installed fiber optic cables at 86 of its subscribers' residences in Toronto, Ontario. Telephone, FM radio, and video services are offered over this Canadian system. P. Chouinard et al., "Description and Performance Review of the Yorkville Integrated Service Fiber Optic Trial," Conference Digest, ICC 1979. The French PTT is sponsoring a large scale trial of fiber optics technology in Biarritz, France. By the end of 1982, the first few of what will ultimately be several thousand subscribers will have access to a complete range of services, including television and telephone, all supplied via a fiber cable. M. Trebeux and E. LeCocquil, "Multi-Services Optical Network," National Telecommunications Conference Record, 1980. For a general information survey of these and additional fiber optic local loop experiments, see R. J. Wills, "Subscriber Loop Applications of Fiber Optics," Conference Records, Electro 1981.

ing "innovative cable or telephone technologies that require joint operations." This proposal is a classic case of too little too late. As this Commission's new "unregulatory" philosophy so insistently observes in other areas, the very existence and fact of regulation erects significant barriers to technological development and investment. Given the abominable history of this Commission's administration of a "waiver process" for telephone company provision of cable service to rural America,[7] and a reviewing mentality that sees the omnipresent spectre of "cross-subsidy" lurking in cable service provided by rural telephone co-operatives,[8] a promise of a possible waiver for "innovative" proposals will not provide the regulatory certainty required for multi-million-dollar telephone industry investments in local loop fiber optic research, development, and deployment. Nothing short of complete repeal of the telephone company-cable cross-ownership prohibition will do, and the national public interest demands no less.

I am hopeful that the Commission—if not also its staff—is prepared to act with intelligence and a sense of reality. Anti-competitive regulation in the guise of pro-competitive policy has ruled this area long enough for us to asceratain the detrimental results. I look forward to a rulemaking proceeding to eliminate this pernicious prohibition—the sooner the better.

---

[7] *Elimination of the Telephone Company-Cable Television Cross-Ownership Rules for Rural Areas*, Separate Statement of Commissioner Joseph R. Fogarty, —— FCC 2d —— (November 5, 1981).

[8] *Id.*

31

FCC POLICY ON CABLE OWNERSHIP

A Staff Report by

KENNETH GORDON
JONATHAN D. LEVY
ROBERT S. PREECE

November 1981

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF PLANS AND POLICY
WASHINGTON, D.C. 20554

Part I

Chapter 1

Introduction and Summary of Conclusions

A. *Origin and Scope of The Study*

In October 1980 the Federal Communications Commission directed its staff to study the Commission's rules on ownership of cable systems.[1] Five issues were to be examined.[2] The first was the rule barring the cross-ownership of cable systems by a telephone company serving the same area.[3] This investigation considers cable-telco crossownership generally and goes beyond other recent Commission investigations and rulemakings on crossownership.[4] The second issue was whether to allow the ownership of many local cable systems by the same company. Multiple system operators (MSO's) are a prominent feature of the cable industry.[5] Currently, the Commission has no rules limiting the number of systems an MSO may operate. The third issue was whether cross-ownership between television stations and cable systems within the Grade B broadcast contour should be per-

---

[1] See FCC News Release, October 22, 1980. The proceeding from which this study emanated is CC Docket No. 78-219. The instant concern of the Commission was with waiver policy standards for rural cable-telephone company cross ownership (see 47 CFR 63.55). Since the rural issue is being examined elsewhere in the Commission (CC Docket 78-219) we do not cover it in this study.

[2] Since that time questions have also arisen about the desirability of foreign ownership of cable. An examination of the issues presented in foreign ownership is under way, and its conclusions will be available to the Commission in the fall of 1981.

[3] 47 CFR 63.54.

[4] CC Docket 78-219.

[5] See Chapter 6, *infra*.

mitted.[6] The fourth issue was the prohibition against cable ownership by the major commercial networks.[7] The fifth issue was "separations," *i.e.*, whether cable operators should manage their facilities as pipelines, leasing some or all of their channels on a non-discriminatory basis to those who wish to transmit programming or other services.[8]

B. *Organization of the Study*

The issues examined in this report all concern cable ownership policies.[9] Each raises distinct (albeit occasionally overlapping) policy issues, however, and affects different interests. As a result there are five distinct reports in the overall study, to facilitate use by readers interested in less than ownership policy in general.

The final section of this chapter is a summary of the basic conclusions and policy recommendations of the entire study. Detailed support for the positions presented appears in the chapter corresponding to each issue.

Part II of the study provides information important for an understanding of each of the ownership issues examined. Therefore Chapters 2 and 3 are intended to be

---

[6] 47 CFR 76.501.

[7] *Ibid.*

[8] This suggestion was strongly supported in The Cabinet Committee on Cable Communications, *Report to the President*, 1974 (The Whitehead report). The case for separations has been made in terms of enhancing access, not economic competition. Separations still has some support, but has not been an active issue recently. See Stanley M. Besen and Robert W. Crandall, "The Deregulation of Cable Television," 44 *Law and Contemporary Problems* at 120-121 (Winter, 1981).

[9] Separations policy is indirectly related. See *Report to the President* (*supra*, n. 7) for the argument that at least some of the media crossownership prohibitions are unnecessary in the presence of a separations policy. (Recommendation 3, at 31-33.) This conclusion is not extended to telephone companies, however. (See Recommendation 4, at 33-34).

read in conjunction with any or all of the chapters that deal with the specific ownership issues in Part III.

Chapter 2 contains background on the cable industry. The basic technical characteristics of cable are outlined and recent developments likely to affect cable's "capabilities" are reviewed. A brief historical survey of the industry, including the effects of regulation on cable development, is provided. Finally, the chapter examines in some detail the various markets that cable serves or has the potential to serve, and identifies the sources and nature of competition in these markets. Some discussion of related markets, such as programming supply, that might be affected by cable ownership rules is included.

Chapter 3 presents general issues about ownership rules or a separations requirement for cable. The meaning of consumer welfare, in various dimensions, is explored in an attempt to provide an understanding of the benefits and costs of the present rules and of proposed changes in those rules. More specifically, the chapter begins by examining the economic aspects of consumer welfare, including the question of what forces determine the services provided by cable, how they are produced, as well as how they are distributed—that is—who gets them. Paralleling the economic concerns are considerations of First Amendment rights and their relation to cable access. The latter issue is also analyzed in Chapter 3 and is linked to the economic aspects of ownership policy.

Part III of the report contains the chapters that analyze each of the five issues and provide support for specific policy recommendations. When read in conjunction with Part II of the report, each chapter may be used by itself.

Chapter 4 covers the broadcast-cable crossownership prohibition. Chapter 5 examines the growth of multiple system operators (MSO's) to determine whether or not the growth of large firms within the cable industry itself

presents problems that the Commission should address. Chapter 6 covers the crossownership issue for the three commercial television broadcast networks.

Chapter 7 examines the advantages and disadvantages of a separations policy for cable. Although separations (severing the link between the ownership and operation of a cable system and the determination of what services it carries) is not an ownership policy as such, proponents have argued it may eliminate some of the problems associated with crossownership.

Finally, Chapter 8 examines the telephone-cable crossownership problem. A number of special features, including rate of return regulation, ownership of pole and conduit space, and a local switched service monopoly position characterize the telephone system and raise problems not shared by other cases of crossownership.

Throughout, the report attempts to minimize the use of technical economic terms and arguments. Except where absolutely central to the discussion, such arguments have been placed in the footnotes or, in cases where the treatment is both technical and extended, in an appendix.

C. *Summary of Conclusions*

We find that the underlying goals of the Commission's ownership policies—the promotion of competition in the economic marketplace and in the marketplace of ideas—are met when a wide range of media, both video and non-video, is available. Our analysis suggests that the market for video programming and many of the other services that cable can provide is workably competitive [10] and in most cases not susceptible to monopolization. We see little danger arising from horizontal control, either

---

[10] See Chapter 3 for a discussion of this term. The Commission has, from time to time, found it relevant to assess the competitiveness of submarkets such as video program delivery or radio services.

in local video markets or in national markets (*i.e.*, the franchising and programming markets) associated with cable.[11] Therefore, we believe that in general a policy extending free entry into cable to all interested firms is most likely to contribute to a rapidly growing, technologically dynamic industry that meets consumers' needs. Consumers' preferences can best determine what cable firms provide, and the incentives of entrepreneurs are more likely to shape an efficient industry structure than a predetermination by government policy-makers. Changes in the structure of the mass communications industry since the cable ownership rules were adopted have removed whatever need the Commission once saw for such rules. These changes will have even more impact in the future.

Therefore, we make the following specific recommendations:

(1) The rule that prohibits broadcasters from owning cable systems in their own areas should be rescinded.[12]

(2) The provisions in that rule that prohibit cross-ownership of cable by the major commercial networks should also be dropped.[13]

(3) The Commission should not place any limitations on the number of cable systems a multiple system operator may own or on the number of subscribers it may serve.[14]

We are aware that some cases of market power may exist or that unforeseen problems may arise in the future.

---

[11] Horizontal control refers to the ability to directly affect the price and other terms of exchange in a particular market.

[12] 47 CFR 76.501. See Chapter 4.

[13] *Ibid.* See Chapter 6.

[14] At the current time there is no rule on how many local cable systems a single firm may control. The issue is discussed in Chapter 5.

These do not appear to be so numerous, so comprehensive, or so likely that either comprehensive prohibitions such as the cross ownership rules, or flat numerical restrictions on ownership, are desirable. Rather, reliance on enforcement of the anti-trust laws can remedy those few situations that are unacceptably lacking in competition. In this fashion the cable industry will be free to shape itself in the patterns that best meet the differing needs of individual markets, and consumers will obtain the benefits of an efficient industry organization.

Because most of the markets in which cable operates are workably competitive,[15] because the cable industry is still in a stage of rapid growth and experimentation, and because cable entrepreneurs have strong incentives to respond to and provide for the overall needs of cable consumers, we conclude that cable operators should retain the primary responsibility for determining what cable programming and other services should be available on their systems. Therefore:

(4) We recommend that the Commission *not* enact a separations requirement for cable operators in most circumstances. An exception to this conclusion would arise in the event of telephone company ownership, and is discussed below.[16]

Cable operators do not now exercise total control over what is carried over their facilities. FCC rules mandate carriage of all significantly viewed local broadcast signals, and local franchise authorities can and do require cable operators to provide a wide variety of facilities, services and program options as a condition of the franchise. Even more important than these requirements are the profitmaking pressures on the operator for providing a

---

[15] This term is defined in Chapter 3, at page 33. See n. 9.

[16] See recommendation (5) on page 8. The general issue is expored in Chapter 7.

high quality, diverse, and reasonably priced set of offerings to consumers.

Revisiting the separations question would be appropriate should cable become the means by which of a substantial majority of communications services is provided. At present a monopoly outcome seems far from certain. Therefore, we recommend no general separations policy.

Finally, we believe that, for the most part, the same conclusions about TV markets reached in connection with broadcasters, networks and MSO's apply to telephone ownership and operation of cable systems. But in the market for non-video services, the potential for effective competition is less imminent.

Elimination of the cable-telephone crossownership ban before there is some likelihood of competition (or at least potential competition) for local loop services would seriously limit consumer alternatives.[17] While cellular, XTEN, and perhaps other technologies offer potential completion in local services, their future roles remain uncertain. In addition, cable crossownership now may add significantly to the difficulty of achieving cost based telephone rates. We would like to stress that these problems are a consequence of the exclusive franchise, rate base regulated nature of the telephone industry and do not stem from cable.

Although the objective of deregulation is to allow the marketplace to provide the services desired by consumers, this goal requires freedom of entry by potential suppliers. In most local telephone and cable markets, free entry does not now exist. Therefore deregulation of crossownership is not yet possible. We do believe, however, that as long as the services people desire are provided at reasonable cost, it should not be the role of government to select the organization that provides them. Thus the crossownership ban may not always be necessary. Two

---

[17] The term "local loop" refers to the pair of copper wires that connects each telephone subscriber to the central office or switch.

developments could ease the problem: (1) competition for the local loop could arise from new technologies or (2) as narrowband cable technology stabilizes it may become possible to insure access to, and competition in that narrowband technology. In these circumstances cross-owned systems may become feasible. Chapter 8 describes such a regime (separations), and explains why it cannot be relied upon to protect competition given the present state of technological knowledge.

We are mindful, however, of the expertise the telephone company may be able to bring to cable development. If the crossownership ban were to retard technological change in either industry, the cost to consumers might be high over the long run. Therefore, the Commission should be flexible in granting waivers from the crossownership ban whenever either a telephone or a cable company proposes an experiment that requires closely integrated cable-telephone operations.

Finally, leaseback arrangements, which are currently available, but not extensively used, could provide a route for taking advantage of any economies resulting from joint operations.

In sum we further recommend that the Commission:

(5) Retain the basic features of the current cable-telephone crossownership ban,

(6) expand and encourage the use of leaseback arrangements to take advantage of whatever joint economies may be available,

(7) expand and encourage the use of waivers of the rule when applicants propose innovative cable or telephone technologies that require joint operation, and

(8) continue to monitor both competitive and technological developments that may make possible ending the ban entirely.

* * * * *

Chapter 8

Telephone Ownership of Cable

A. *Introduction*

Telephone companies and cable systems both provide electronic information services over wire. Many services can be provided by either one. With adequate switching and consumer premises equipment cable companies can do just about anything that a telephone company can. With some changes in telephone systems, telephone companies can do virtually anything that a cable company can.[1] The potential for competition with the local telephone monopoly is central to arguments to ban cross-ownership of cable and telephone facilities and joint operation of these facilities.[2]

To encourage flexibility in the provision of new services and to protect cable interests, the Commission has ruled that a local telephone company may not operate a cable system in its service area. Other reasons for the ban that were cited by the Commission in its crossownership prohibition are the possible cross-subsidy between cable

---

[1] See *USITA Member Letter* (April 20, 1981), for a description of a cable applicant which is applying to provide telephone service. Because twisted pair wire used for telephone signals is narrowband, it cannot carry video transmission of the quality necessary to allow television signals without significant cross-talk problems. Segregation of digital carrier systems can allow the telephone company to provide high speed data and even video transmission over existing local loop between cable and plant telephone facilities. (See "New technique could allow video transmission over phone lines," *Bell Laboratories Record*, 503-503, October 1980.) New telephone technologies, especially local use of fiber optics may eliminate any remaining distinctions.

[2] Several other technologies are potential competitors in the provision of local service. These include private microwave (XTEN), cellular radio, satellite, and others. Whether these services become competitive depends on cost considerations and may also be affected by Commission decisions.

and telephone services; the argument that cable is an "infant industry," which can develop fully only if protected from telephone control; and the problems rising [*sic*] from telephone companies' ability to deny access to independent cable systems through control over poles and conduits.[3] The prohibition on crossownership is waived only in cases where cable service could not otherwise be provided, or where "other good cause" [4] can be shown.

Because of the high fixed costs and low variable costs of cable provision, cable facilities are likely to be provided by a single firm. This situation is reinforced by state and local franchise regulations. Therefore, if telephone ownership of cable facilities becomes prevalent, it is unlikely that a competitive cable system will develop. While there are a number of competing sources of entertainment broadcasting,[5] there are currently few substitutes for local telephone service.

---

[3] To a large extent, the two last problems have been eliminated or reduced by the development of the cable industry and by legislation. The cable industry has grown rapidly in recent years; it is no longer appropriate to think of it as an infant. Likewise, pole attachment legislation has given independent cable operators recourse if the telephone company is limiting access to poles at reasonable rates.

[4] Clear and substantial economies in construction or operation are defined as satisfying the "other good cause" criterion in the Sugar Land Report and Order (76 F.C.C. 2d 230 (1980)).

[5] See the preceding chapters. These alternatives include over-the-air broadcasting, DBS, MDS, STV, movie threaters, live theater, live sports events, newspapers and magazines, and other entertainment and information activities. See, also the *Staff Report on Policies for Regulation of Direct Broadcast Satellites* 11-32. This argument has two logical consequences. First, as technologies that can compete with telephone company services are developed, the need for cross-ownership restrictions is reduced; second, if cable does not develop these two-way services (i.e., if it does not become an actual or viable potential competitor with the telephone company in basic telephone services), many prospective benefits arising from the ban will not develop.

Section B of this Chapter discusses the advantages of crossownership. Section C examines the disadvantages of crossownership. Section D considers several alternative regulatory policies including (1) dropping the ban upon appropriate state regulation; (2) a regulatory approach that relies on cost manual type cost allocation and on a "partial separations" policy for telephone company owned cable systems; and (3) maintaining the present ban. We conclude that the ban must be retained for the time being.

The Commission now bans crossownership and operations between CATV systems and telephone companies in the same service area.[6] Telephone companies however, are allowed to own and operate cable systems outside of their own service areas and may also own cable facilities if they are leased back to an independent cable system.[7]

---

[6] Final Report and Order 21 FCC 2d 307 (1970).

[7] The ban is contained in the Final Report and Order, 21 FCC 2d 307 (1970). Under the order, independent cable systems must be allowed the option to construct their own facilities; the telephone company cannot force them to accept a telephone company owned facility. In practice, the lease-back of telephone company provided facilities has been uncommon. (Thus at present only 12 telephone companies post lease-back tariffs). One reason for this scarcity however, may be a Commission effort to discourage telephone company ownership of cable facilities.

While the Commission did not specifically find that anti-competitive behavior existed, it argued "that the prevention of such possible abuses fully warrant our policy findings herein, and the new rules which will implement them." (21 FCC 2d at 329, 1970).

While the Commission banned cable-telephone crossownership in general, it admitted that in some areas cable service may be possible only if provided by a telephone company and that in these instances an application for waiver of the crossownership rules would be considered.

Because the waiver process is costly and the standards on which waivers were to be granted were unclear, the Commission has broadened the waiver standards for rural areas. It now presumes that crossownership is necessary if sparsely settled areas are to receive cable services. On November 29, 1979, the Commission instituted

B. *Advantages of Crossownership*

1. *Background*

The 1970 *Report and Order* bans crossownership between cable and telephone facilities because of the potential dangers. Crossownership, however, may also offer benefits. Joint construction and operation may lower engineering, construction, maintenance, or operations costs. If these savings are large enough, then the prohibition on crossownership is costly and should be continued only if the ban results in clearly offsetting benefits. Our society

---

a waiver presumption policy in jurisdictions with population densities of less than thirty homes passed per cable mile. 81 FCC 2d 233.

This general waiver policy allowed crossownership between cable systems and the local telephone company within its franchise area. On October 9, 1980, the Commission defined the area within which the thirty homes per mile measure is to be applied as the cable franchise area (because of the likelihood of gerrymandering) 86 FCC 2d 254, but it reversed this decision on reconsideration, and decided that the service area is the appropriate standard for determining the waiver presumption. (46 *Fed. Reg.* 31418, June 16, 1981). It argued that it could control gerrymandering on a case by case basis.

The presumption retains the preference in favor of independent operation of cable and telephone systems. Thus, the policy allows for rebuttal of the presumption by a cable company's demonstration that it will serve the area itself.

The telephone company/cable television rule may also be waived "upon showing of good cause." *See* Section 63.56(a) of the Commission rules, 47 C.F.R. § 63.56(a). In this regard, the Commission has stated that:

> The right of a telephone company to attempt to meet that high burden is not automatically cut off by the possibility of independent CATV operation in the area. This burden will not be met, however, by a telephone company's merely showing a possible marginal advantage in joint operation over independent operation. 76 FCC 2d at 235-6.

Even though the Commission recently proposed eliminating the ban in rural areas (*See Notice of Proposed Rulemaking in CC Docket No. 80-767*, 84 FCC 2d 335 (1981)), the general prohibition on crossownership in more populated regions has been little modified since its adoption in 1970.

preserves a bias in favor of allowing firms or individuals to enter any markets they wish. Those seeking to prohibit crossownership must make a affirmative case that there are strong social interests in keeping certain firms out. It is not sufficient to argue that the advantages of cross-ownership are small.

Telephone and cable systems are likely to maintain separate facilities (at least in the short run) because of technical differences between cable and telephone operations. This is especially true where telephone or cable plant is in place.[8] In areas of rapid population growth, substantial additions to telephone stock and construction of new cable systems could be undertaken jointly if costs would be lowered by doing so. For example, coaxial cable could be used for transmission of both telephone and wideband communications.[9]

2. *Economies*

Even if different transmission equipment is used to carry narrowband and wideband communications, some economies could be realized in construction by lashing together coaxial cable and paired wire.[10] Such physical integration might be costly where separate companies own

---

[8] While some telephone equipment exists almost everywhere, development of new towns or rapid suburban growth may result in instances where the existing telephone facilities are totally inadequate and substantially new equipment must be constructed.

[9] See, for example, Rural Electrification Administration, "The Economics of Rural Telephone and CATV Integration," August 22, 1977. Most of the advantages cited here, however, relate to the lower cost of capital faced by telephone companies. In that article, the lower cost of capital was due to subsidies from the federal government through the Rural Electrification Administration.

[10] While lashing makes economic sense where the proportion of cable and loop plant is known in advance, in practice this decision is likely to differ for each use. If so, many of the potential economies evaporate.

each facility. Companies may be concerned about damage done to their own facility in the course of work done by the other company. Some economies in repair and other work could be achieved through coordination. Such coordination is likely to be difficult to organize if one company believes that it will benefit from delays suffered by the other company (i.e., where they provide competing services).

There may be other economies of joint construction. Common conduits and poles are frequently used to provide cable and telephone services. Substantial savings may be realized if cable can be laid at the same time as telephone wire (especially if cables are buried). The labor required to wire customer premises may be reduced if cable hookups and telephone attachments are provided by a single crew. A combined company is more likely to take the demands of both systems into account in planning the type of poles used and the delivery technology.[11] If cable demands are not taken into account, increased costs will result from incorrect spacing, moving electric wires, etc. Economies also may be realized through joint maintenance. When wires are damaged by storm or accidents, it may be possible to send one crew to restore both telephone and cable service.[12] Likewise simultaneous repairs of cable damage in underground conduits may be far less costly than separate repairs.

If cable and telephone services are offered by one company, fixed administrative and overhead costs will be

---

[11] A telephone company could take potential cable demands into account without crossownership. Regulation may make it unwilling or unable to do so.

[12] "A Study of the Technical and Economic Feasibility of Providing Narrowband and Broadband Communications Services in Rural Areas: Executive Summary" BNR INC., Palo Alto, California, August 1978 argues that telephone repair personnel must be retrained before they could undertake such joint repairs. Such retraining would be wasteful in areas where specialized crews could be fully employed, and where travel costs are low.

spread more widely. Costs of billing can be reduced, and consumer convenience increased, by using a single mailing. Combined operations might allow hiring of specialists that neither company could afford on its own. Even in large systems, division of labor may be increased by crossownership.[13] Finally, in small companies the total number of managers might be reduced by joint ownership, and entrepreneurial skills might be more fully employed.

Some argue that increased telephone involvement in cable provision might result in service being extended to new areas faster.[14] If telephone companies can realize the economies discussed above, they may be able to operate where an independent cable system can not.[15] Telephone companies already have access to public right-of-way [*sic*] and experience in negotiating with local regulatory boards. To some extent this access represents a real social savings since a telephone company will be able to avoid costs that the cable company would have to endure. On the other hand, if the telephone company is awarded a cable franchise through favoritism rather

---

[13] Large telephone exchanges seem likely to take advantage of these economies as they typically specialize very highly. (In general, the availability of consultants willing to work on a part time basis will reduce the need to expand in order to increase specialization of labor.)

[14] Thus, Commissioner Joseph Fogarty has argued "[i]t is time for the Commission to question whether our existing rule and waiver standard impose too great a burden on today's consumers in terms of foregoing cable service which can be provided *now* by telephone companies in favor of vague *future possibility* of service by independent operators." Separate Statements of Joseph R. Fogarty in 82 FCC 2d, 254.

[15] Telephone companies also may be able to shift profits from regulated telephone operations. This possibility (discussed below) raises an entirely different set of issues. A telephone company might wish to enter a market even if it is not the lowest cost provider of service if entering this market allows it to evade regulation.

than because it will provide the best possible service, the result could be inefficient.

Telephone companies typically have better access to capital than do cable companies. Rural telephone companies, especially cooperatives, have historically been able to obtain low cost government loans.[16]

Rural Electrification Administration loans and loan guarantees are generally made for the purpose of encouraging nationwide telephone service. Neither Congress nor the Commission has explicitly determined that nationwide rural cable service is in the public interest or that it must be subsidized by anyone.[17]

Telephone companies also may be able to introduce service more rapidly than independent cable companies because of their knowledge about consumers demographic, financial, or geographic patterns. This type of information allows real cost savings, and must, therefore, be considered a potential advantage of crossownership.[18]

---

[16] Rural Electrification Administration "The Economies of Rural Telephone and CATV Integration" August 22, 1977. A low cost government loan does not reflect real economic savings. Since this is the case, the use of government funds for the provision of cable service to rural areas when this service is provided by telephone companies is questionable. Therefore, the advantage that telephone companies may have in attaining low interest loans through the REA cannot be considered to be a real economic advantage of telephone company provision of cable service.

[17] Nationwide telephone service is an important goal of the Commission and Congress. Neither Congress nor the Commission has formally determined that universal nationwide availability of cable, at the non-compensatory prices that are likely to be required to bring this about, is justified. As this report emphasizes, many of the services that cable provides can also be provided over other media or technologies. Translators can provide rural video coverage at a far lower cost than cable. There thus appears to be no reason to assume that nationwide cable availability need be a national goal. Congress has, however, provided some funding for rural cable systems through REA and the Rural Development Act of 1972 Pub. L. No. 92-419, §§ 109 & 118, 86 Stat. 659, 663-4 (1972).

[18] This information could be sold to an independent cable system. Again, the real advantage of allowing the telephone company

Finally, allowing telephone companies to compete increases the number of qualified bidders for cable franchises. While there are already many bidders for most non-rural cable systems, telephone companies have extensive engineering know-how, some of which could be applied to cable.[19] Telephone companies are already allowed to operate cable systems outside of their telephone service areas; therefore some of these economies could be gained without any changes in Commission policy. Nevertheless, consumers might benefit if telephone companies were able to bring specific expertise about conditions in their own service areas to cable.

The advantages of crossownership discussed so far revolve around potential coordination between the cable and telephone entities. Far more important advantages may result if crossownership leads to technological advances in the cable or telephone industries. Likewise, crossownership has very high costs if its stifles technological advances.

3. *Technological Progress*

Crossownership could either limit or encourage the development of communications technologies. Technological progress potentially has greater long run significance

---

to provide cable service is the avoidance of transactions cost rather than the loss of information.

[19] Not all of a telephone company's engineering experience can be easily transferred to cable. In addition to the obvious technical differences between narrowband and wideband communications channels, the degree of reliability that is typically built into telephone systems is far higher than that typically required of cable. (See "A Study of the Technical and Economic Feasibility of Providing Narrowband and Broadband Communications Services in Rural Areas, Executive Summary," BNR INC., Palo Alto California, August 1978.) A one wire system designed to the reliability standards set for telephone service would be more expensive than a coaxial system where less reliability could be tolerated. Thus, the advantage of a one-wire system, even where the system is to be created *de novo*, might be minimal or nonexistant.

for consumer welfare than any of the economies of joint ownership that we have considered.

If crossownership significantly accelerated the development of new technologies or services, this would be a powerful argument in favor of dropping the ban. Conversely, if advances would be retarded, this would be a strong reason for retaining the ban. A prediction of the direction of this effect would be valuable, but such predictions are difficult to make, and crossownership is likely to affect technological advances in more than one way.

A crossowned system might have more incentives to innovate because it would be able to utilize fully any new techniques developed in either service.[20] Independent provision might mean that technological advances would be under-utilized or even inapplicable (because, for example, these advances rely on a "one-wire" type system or might have to be shared with another firm).

The counter-argument is that there will be less innovation if competitive pressures do not compel the firm to seek lower costs and better techniques.[21]

Evidence on the conditions that foster technological progress in other industries is ambiguous.[22] Moreover, the evidence that is available does not indicate how local market dominance will affect innovation in the presence of nationwide competition for those local services.

To the extent that joint technological progress in the telephone and cable areas is embodied in physical capital, lease-back arrangements of the sort already described

---

[20] This may be overcome by lease-back agreements.

[21] Rate-of-return regulation may also hamper telephone company innovation since the innovating telephone company would not be allowed to enjoy the profits that its innovation would allow.

[22] F. M. Scherer *Industrial Market Structure and Economic Performance*, Second Edition, (Chicago: Rand McNally College Publishing Company, 1978) at, 407-438. The markets Scherer discusses are not regulated markets. Regulation may have a stifling effect on innovation.

might allow any new economies to be realized. Nevertheless, where risk and uncertainty of outcome are high, such contractually arrangements may be inadequate vehicles for cooperation between telephone and cable companies.

The crossownership rules do allow waivers for "other good cause." Good cause is defined to include cost economies attainable through new technology. (See footnote 4, *supra.*) Therefore, present rules allow telephone companies to reap many of the benefits of technological improvements that they can offer cable.

The existence of potential economies may not be sufficient to compel cooperation, however. For one thing, the cable system may feel that its chances of franchise renewal are better if its owns the cable facility itself. Likewise, the danger of cable rate regulation may be higher where telephone company owned facilities are used by the cable company.[23]

The development of technology is unpredictable. The Commission should be prepared to allow crossownership for experimental systems that attempt to apply new technology to cable. Such a waiver policy would not endanger the incentives to progress generated in both the telephone and cable industries by the increasing range of competition between these systems, but would allow

---

[23] Contracting costs are likely to be high if the cable and telephone companies believe themselves to be supplying essentially the same service. Especially since the telephone company is subject to rate of return regulation, it may wish to exclude its competitor rather than suffer competition. Likewise, if the telephone company believes that it may be permitted to enter cable in the future, it is less likely to wish to encourage independent cable operation. Finally, the costs of reaching an agreement are generally nonzero. Even if the telephone and the cable companies wished to cooperate and believed that there is no essential conflict between their goals, it may still be cheaper for one company to undertake both projects and avoid the inevitable differences that combined operation will present.

progress from joint operations when that seems likely to occur.

4. *Conclusion*

There are some potential advantages to joint ownership of telephone and cable facilities. At a minimum, the degree of cooperation and coordination between these services will be higher where they are operated jointly. Moreover, joint ownership may encourage discovery or use of new techniques that reduce the costs of service.[24]

Our discussion of the potential advantages of crossownership is necessarily somewhat theoretical. There are three reasons for this. First, the crossownership prohibition has been strictly enforced;[25] thus the data on possible economies in urban areas are severely limited. Second, there have been dramatic changes in the nature of the cable business over the past several years. Third, the existing cost advantages or disadvantages of the tele-

---

[24] Some observers believe that improvements in fiber optic communications technology will ultimately make an integrated wideband delivery system using fiber "loops" to the home the most efficient means of delivering voice, data, and video services. (See E. J. Claire, C. Richard Patisaul, and J. C. Wyatt, "Broadband Fisher-Optic Systems: Designs for Now and Near Future," *Communications News*, September 1978, pp. 72-73 and R. Kachulak, "A Rural Integrated Distribution Trial with Fiber Optics," *IEEE Communications Magazine*, January 1981, p. 36.) Some preliminary field trials have already been conducted in foreign countries. Some of these are described in the following Institute of Electrical and Electronics Engineers' conference record papers: R. J. Mills, "Subscriber Loop Applications of Fiber Optics," *Electro* 1981; P. Chouinard, et. al., "Description and Performance Reviews of the Yorkville Integrated Service Fiber Optic Trial," *International Communications Conference*, 1979; and M. Treheux and E. LeCoquil, "Multi-Services Optical Network," *National Telecommunications Conference*, 1980.

[25] Furthermore, the 1956 Consent Degree (see section C-4 below) has heretofore precluded AT&T, the largest telephone company, from provision of cable television services.

phone company are probably less important than the dynamic cost economies that interaction between cable and telephone service may be able to offer. While the economies from joint construction may be small where the telephone plant is already constructed, in the future, whenever new telephone facilities are needed or old facilities must be replaced, far more substantial economies may be realized.

Cost economies need not be proven as a condition for crossownership. Rather, the market should be relied on unless this will lead to problems that cannot be dealt with without government interference. The problems that crossownership may entail, and suggested means for dealing with them, are the subjects of the following sections.

As we argued above, there is a presumption that firms should not be prevented from entering markets. Those who wish to argue against crossownership should be expected to make a strong case. The fact that economies of joint operation may generally be low is not a sufficient argument to ban crossownership. Nevertheless, the following section argues that there are major problems associated with unrestricted crossownership.

C. *Disadvantages of Crossownership*

1. *Introduction.*

The disadvantages of crossownership largely derive from the fact that telephone companies are regulated exclusive franchise monopolists in their local area. These disadvantages can be classified into four groups.

First, crossownership may allow a telephone company partially to avoid rate-of-return regulation on its telephone service. It can do so by attributing costs to the regulated telephone division and revenues to an unregulated cable division.[26]

---

[26] J. B. Duvall and M. D. Pelcovits discuss this problem in the case of private line telecommunications services, which they argue

Second, cable service can compete with telephone services in the areas of alarm systems, data transmission, meter reading, and even plain old telephone service. Telephone companies may be able to forestall this facilities based competition in two-way communications by owning the cable system. Crossownership or cooperative operations will also allow joint-monopoly profit maximization.[27]

Third, the size of some telephone companies relative to the cable industry could allow one or two telephone companies to gain a very large share of the national market in cable.[28]

---

can be deregulated. ("Reforming Regulatory Policy for Private Lines Telecommunications Services: Implications for Market Performance", Office of Plans and Policy Working Paper Number 4, December 1980.) The problem is considerably smaller in that case since private line service is a nationwide telephone offering, and since there exists an interim cost allocation manual to prevent this type of cost-shifting. A major policy difference between the use of cost allocation for deregulation of private line services and for control of cross-owned cable systems is that private line services are already provided with joint or common facilities. This is not the case with cable facilities, but might become the case if crossownership is allowed.

[27] Joint-monopoly profit is the profit earned by two firms acting as a single monopolist. Such cooperation is likely to lead to greater monopoly profits than would competitive behavior. This joint-profit maximization is constrained. Alarm systems can be independent of both cable, and telephone; XTEN type service or direct satellite service like that provided by SBS may eventually offer reasonable substitutes for phone or cable data services. Nevertheless, the use of a satellite for local transmission is not likely to be effective or cheap. Interactive alarm systems are likely to be more reliable than are stand-alone systems, and electronic meter reading is likely to be cheaper than having meter readers check meters several times a day. Therefore some market power is likely to remain.

[28] See *Comments of the National Cable Television Association, Inc.* in CC Docket 80-767 (at. 34-39) (1981).

Fourth, telephone companies control substantial conduit and pole space. Unrestricted control over cable access can give the telephone company a powerful lever to gain control of the cable system or to charge monopolistic rates for access. Rate or pole price regulation can limit exploitation of telephone company monopoly power unless crossownership is allowed.[29]

2. *The Allocation of Costs*

Effective rate-of-return regulation may make it profitable for telephone companies to undertake enterprises that would be unprofitable in the absence of regulation. If telephone companies arbitrarily allocate costs to regulated facilities and revenues to unregulated facilities, they may partially avoid the rate-of-return limitations that regulation attempts to impose. If the telephone company bases a large part of its behavior on avoiding regulation, the most efficient organization of production is unlikely.

Telephone regulation determines an allowable rate of return and permits the telephone company to earn this return on allowed capital, after allowed expenses. As long as regulation effectively limits the telephone company's rate of return, the company has an incentive to attribute costs to the regulated sector. If cable crossownership allows regulated telephone companies to shift

---

[29] Rate regulation gives two motives for crossownership. First, even if the industries were non-competitive, crossownership may enable the telephone company to attribute cable costs to the telephone company rate base or telephone companies revenues to the cable subsidiary. Second, if the cable system and the telephone companies are natural competitors, crossownership allows joint profit maximization and joint monopoly pricing. Because the telephone company supplies a vital commodity to the cable (pole attachments), it could charge a high enough price to absorb most of the cable profits itself and force the cable to charge the joint monopolistic prices to be able to pay for the input. Since it is rate regulated, the telephone company can keep these profits only if they can be attributed to a cable subsidiary.

costs, a powerful incentive toward crossownership (stronger than and in addition to the incentive to increase capital discussed by Averch and Johnson [30]) is created.[31]

---

[30] H. Averch and L. Johnson "Behavior of the Firm Under Regulatory Constraint", 52 *American Economic Rev.* 1053-69 (December 1962). Averch and Johnson discuss distortions caused by rate regulation over the entire entity. Thus, if a telephone company can claim certain capital expenditures as part of the rate base, it may wish to undertake this investment even if it adds nothing to sales or to the attractiveness of the output. When part of the entity escapes regulation, any costs generated in the unregulated sector that can be shifted to the regulated sector represent pure profits.

[31] Assume, for example, that both a telephone company and a cable system can be supported by a community, that the capital stock of the telephone company is $100 million, and that the capital cost of a cable company is $50 million. Make the further simplifying assumption that operating costs are zero for both the telephone and cable operation (all costs are capital costs), that the allowed rate of return is 10 percent, and that a protected telephone monopolist would earn 20 percent if rate regulation were totally ineffective. In this example, each dollar of cable costs that can be attributed to the telephone system will justify a ten cent per year increase in allowed telephone revenue, up to the monopoly level. If all cable costs can be attributed to the telephone system, but all cable revenues can still be attributed to the cable sector, the telephone company could raise its telephone price by 50 percent and earn a 15 percent real rate of return on actual telephone capital. This assumes that the regulatory commission is willing to allow rate increases and that it believes the telephone company's attribution of cable facility costs to the telephone company rate base. If the regulatory commission refuses to grant rate increases for political reasons, the incentives for misallocation of costs are reduced. Such a regulatory policy is of dubious legal or economic value since it may preclude new investment and because it may not allow the recovery of real costs. Depending on the ability of the telephone company to allocate cable costs to telephone operations, very significant increases in apparent telephone revenue requirements may be possible without any change in the underlying costs. When costs can be shifted, the value of the cable system to the telephone company is substantially greater than it would

When costs can be shifted, rate of return regulation may make joint ownership of cable and telephone facilities profitable to the telephone company even if joint provision of cable and telephone service is more costly than independent provision.

This rationale for a crossownership ban is dependent on the assumption that rate of return regulation has held telephone rates below the monopoly level (though not necessarily below the level that could result from competition and contestability), and that the regulators respond to higher costs by allowing higher rates. If regulators ignore reported costs and set rates on other grounds (such as a simple inflation adjustment to historical rates), the incentive to shift costs would likewise vanish, although other problems would develop.[32]

Current Commission regulation limits crossownership only within the telephone service area.[33] As long as costs can be attributed geographically, the current ban appears sufficient to eliminate this danger of crossownership.[34]

---

be to an independent cable company. The value of a cable system to the telephone company will thus equal the sum of the present value of cable profits plus the present value extra telephone company profits generated through cost-shifting.

[32] In general, inflation type adjustments will bear no necessary relationship to changes in costs of telephone inputs. Thus adjusting rates on the basis of inflation may allow excess profits or profits that are insufficient to allow the recovery of investments. Legally such a strategy is very questionable as it might amount to confiscation prohibited under the Fourteenth Amendment.

[33] (21 FCC 2d at 325. (1970)).

[34] This assumes that telephone companies are not able to shift costs when they own cable facilities and lease them to independent cable operators (which is currently allowed). Since most cable operators have chosen to construct their own cable facilities, the effectiveness of local regulatory commissions in determining the assignment of costs has not been tested. It should be noted that the incentives of telephone companies to misstate costs are far less when they must lease the cable facilities to an independent

BEST AVAI

Such cost shifting will be far harder to control if cable and telephone system costs are incurred in one area for the same types of equipment, or are to some extent joint or common.[35]

One of the most difficult aspects of telephone regulation is the assignment of costs to their causes. Cable and telephone systems share a certain amount of capital equipment;[36] allocating shared costs between these capital accounts on the basis of actual cost causation will be difficult or impossible. (See footnote 35 supra.) Maintenance and general overhead costs are difficult to apportion between systems.[37] Regulators cannot simply compare costs facing joint cable telephone systems with costs in independent systems in other areas. Both cable and telephone facilities differ across regions; special geographic or demographic factors may cause substantial differences in cost and total costs of combined systems may differ from independent costs. No simple yardstick is available.

---

operator than when they can own an unregulated cable subsidiary. As long as the cable company is independent, any lease revenues fall under rate of return regulation, but if the cable company is owned by the telephone company, the cable can be charged low rates and show high profits outside of rate regulation.

[35] Joint costs are shared costs that must be borne regardless of the proportion of the goods produced (like overhead). They involve no tradeoff between the goods. Thus their allocation cannot be based on supply characteristics alone. Common costs are shared costs that involve tradeoffs, and so can be assigned on the basis of use without economic distortion.

[36] Typically cable and telephone systems share poles or conduit space.

[37] Ramsey pricing theory (see, for example, E. E. Zajac *Fairness or Efficiency: An Introduction to Public Utility Pricing*, (Cambridge, Massachusetts: Ballinger Publishing Company, 1978) sets price in a way to recover full costs, and is implicitly, therefore, an economic theory of shared cost allocation. In practice, however, more arbitrary means of allocation must be selected.

ABLE COPY

Problems of cost-shifting cannot be ignored since the Commission is responsible for ensuring that rates are cost-based. The problems of cost-shifting may not be insurmountable. The Commission may be able to deregulate one part of a telephone company operation without deregulating the remainder.[38] Nevertheless, this possibility depends on an effective cost separations mechanism at minimum. No such mechanism currently exists to separate cable costs from telephone costs; a major regulatory proceeding would be required to develop and implement one. Further, both accounting and engineering staff would be hard pressed to apply such a cost allocations manual, even if one could be devised.

Section D.4 of this chapter argues that a well designed separations policy[39] someday may be able to limit the incentives of the telephone company to shift costs from the cable entity to its telephone business. Nevertheless, if the Commission were to permit crossownership, it might simply have to accept a certain amount of cost-shifting.[40]

3. *Potential Competition*

Cable and telephone suppliers can already compete in the provision of many two-way services. Where cable is inde-

---

[38] Pelcovits and Duvall make this argument. (See n. 25 *supra*). They are discussing an already regulated service. It might be costly to extend regulation to a new area.

[39] See chapter 7, for a discussion of separations policy in the general cable context.

[40] If the Commission decides to allow crossownership, it will shift a substantial responsibility onto state regulatory commissions (PUCs). It may, therefore, wish to consider removing the crossownership ban only when the state PUC asks it to do so. That is, the interests of the local franchise board may be in conflict with the interests of the state PUC. Because the PUC will be forced to determine cost allocation, its interests must be considered. This is not to say that the Commission must decide to allow crossownership if the state PUC wishes. A substantial part of local costs are reflected in the interstate revenue requirements, and therefore come under the Commission's jurisdiction.

pendently owned, the threat of cable entry into two-way markets may restrict the ability of the telephone company to behave as a monopolist. If the facilities were jointly owned, this constraint would not exist. Telephone companies have other actual competitors and potential competitors; nevertheless, cable has more potential to provide telephone-like services in the near future than does any other carrier.

Cable systems provide competition with the local telephone company both in two-way services and in access to the increasingly competitive interstate telecommunications market. In some cities, for example, Satellite Business Systems (SBS) proposes to rely on cable facilities for origination and termination of some of its transmissions.[41] Without competitive access to the local consumer, the potential for interstate competition is limited.[42]

The problems of cost-shifting are present in any telephone company expansion into service areas; in the cable area the likelihood that potential competitors will be eliminated is even more serious. Cost-shifting is a result of monopoly and of partially effective regulatory control. If potential competition or actual competition is prevalent, cost-shifting will be highly limited.

Cable systems are not the only possible competitors for local loop type service. The appearance of other entrants would reduce the need for cable competition to constrain telephone company market power. Some argue that competition in local loop facilities could develop rapidly,

---

[41] *See M/A-Com, Inc., Annual Report* at 14-16 (1980). See also "Belt-Tightening Gotham to Use Manhattan Cable for Data Sending," *Variety* at 42 (July 8, 1981).

[42] In this case, the difference in potential damages from high levels of AT&T involvement in the provision of cable services (as opposed to other telephone companies) becomes important. AT&T is the dominant carrier in interstate carriage as well as in local service. Because of this, it has more reason to wish to monopolize local loop services than would an independent telephone company.

and that the traditional bottleneck could be circumvented.[43] If new technologies fulfill their promise, the need for ownership restrictions may be eliminated. Nevertheless, at present the ability of these new technologies to provide competition with the full range of telephone services, if they develop at all, remains largely speculative. Cable has more immediate prospects for providing some competitive services, and long run prospects for eliminating the "local bottleneck" altogether.[44] The local monopoly held by telephone companies and the ability of cable to provide similar services, not any special attributes of cable entertainment, makes telephone control over the cable medium undesirable.

4. *Special Issues Involving AT&T*

Much of the opposition to cable-telephone crossownership is motivated by a fear of AT&T.[45] AT&T serves most of the larger metropolitan areas; these areas have become most attractive for cable systems. AT&T's sheer size, its nationwide operations, and its vertically integrated nature raise serious concerns about Bell entry into new industries.[46]

This Report argues that cable concerns are largely local. A telephone company, whether AT&T or the smallest independent, has extensive market power in its fran-

---

[43] See, for example, D. N. Hatfield "Local Distribution—The Next Frontier," presented before the Ninth Annual Telecommunications Policy Research Conference, Annapolis, Maryland, April 29, 1981. These new technologies include independent cellular radio, and microwave radio technology such as XTEN.

[44] *Ibid.*

[45] See NCTA *Comments, supra.*

[46] The issues of nationwide cable provision by a single entity have already been discussed in Chapter 5 of this report. It was argued that nationwide cable coverage by a single entity may be undesirable. Nevertheless, the way to deal with that problem is not to maintain cable-telephone company crossownership rules, but to address the problem of cable concentration directly.

chise areas. AT&T differs from an independent telephone company because AT&T has more extensive capital resources than any independent telephone company markets and because AT&T's Long Lines division is the dominant interstate carrier. Recent interpretation of the 1956 Consent Decree[47] makes it unclear whether AT&T would continue to be restraint from entering the cable market.[48] Limits on AT&T may be further modified by Congress. The National Cable Television Association (NCTA) has argued that under AT&T's proposed interpretation of the decree, Bell would be allowed to enter the cable market.[49]

If the consent decree does not prohibit Bell entry into cable, the Commission should treat Bell like any other telephone company unless it can specify special circumstances that justify the difference in treatment. The size differential by itself is not central. Both Bell and independent telephone companies have much the same incentive to enter cable; protection of their local monopoly power. Because cable provides competition to local facilities, concerns about local monopoly and access to interstate services should be the concerns that guide Commission policy.

5. *Restricting Access*

The Commission cited the ability and apparent willingness of telephone companies to deny access to independent cable companies as one justification for the crossownership ban.[50]

---

[47] *U.S. v. Western Electric et. al.*, Consent Judgment, January 24, 1956, U.S. District Court for New Jersey, 13 RRLN3; 1956 Trade Cases 71, 134.

[48] U.S. v. Western Electric Inc., and American Telephone and Telegraph Company, U.S. District Court for the District of New Jersey Civil No. 17-49, September 5, 1981.

[49] NCTA *comments, supra*, pp. 49-50.

[50] 1970 *Report and Order* (21 F.C.C. 2d) at 308, 323-324.

Power to deny access takes several forms. Of most immediate concern is telephone company ownership of poles to which cable may be attached and conduit through which cable may run. The Commission has authority (under the Pole Connection Act) to "regulate the rates, terms, and conditions for pole attachments" except where a state assumes regulatory responsibility.[51] In spite of this law, cable companies argue that problems of access remain substantial.[52]

The problem of pole access does not by itself justify banning crossownership. If the telephone company were allowed to sell access to independent cable companies it could, in principle, develop a price schedule that exactly exhausted all cable monopoly profits and transfer these to the telephone company with no loss in consumer welfare.[53] Unless a telephone company believed it was able to achieve lower costs through direct ownership, it would be content to charge high prices for independent access. Where cable and telephone companies offer competitive services, however, access pricing could be used to reduce the cost of acquiring cable companies (by reducing cable profitability and hence the value of the system). The telephone company, therefore, would jointly operate cable and telephone facilities to maximize total profits.

The ability of telephone companies to control access means that lease-back agreements must be carefully scru-

---

[51] Cable Connection Act, P.L. 95-234. As of January 28, 1981, 19 states plus Puerto Rico, had assumed responsibility for regulating pole attachments.

[52] Their arguments are three. First, the pole attachment statute expires five years after its enaction, i.e., in 1983; second, many states have preempted federal authority without providing an adequate substitute; and third, the enforcement process is sufficently slow that pole access remains a substantial barrier. (See, for example, NCTA *Comments supra* at 13-14.

[53] See the discussion of vertical integration in Appendix B.

tinized. Where telephone companies have control over access, they may have the incentives and ability to force cable systems into lease-back agreements. By doing so, they may be able to limit cable competition.

The pole attachment rules constrain the ability of telephone companies to abuse control over access. Because of this, the Commission should look on lease-back tariffs, where both the telephone company and the cable company are agreed on the rates and terms, with little reservation. With the controls already in place, lease-back would enable the telephone system and cable operators to enjoy many or all of the benefits of crossownership. The Commission should not allow telephone companies to force lease-back on cable franchise owners; it also should not, however, preclude their use.

6. *Conclusion*

The problems involved in cable-telephone crossownership are sufficient to overcome the social presumption in favor of allowing unrestricted crossownership.[54] Cable sys-

---

[54] This is not to say that the Commission should not continue its rural waiver program. Where cable service would not be otherwise provided, or where there will be a serious time lag between implementation of cable service by the telephone company and an independent cable company, the competitive advantages of independent cable operation are not available. If the Commission is willing to allow the state and local governments to worry about cost allocation problems (despite the fact that these problems spill over into interstate rates), the Commissions waiver process is quite reasonable. This is also not to say that the Commission must continue to impose its regulations until non-cable technologies competitive with local telephone services develop. If cable systems do not develop their two-way facilities in competition with local loop telephone company facilities but instead concentrate on the broadband entertainment market to the exclusion of all else, the ban serves little purpose and should be eliminated. The belief that cable systems can compete with telephone company appears to be justified by recent developments in the cable industry. The

tems provide a viable substitute to many telephone services. Allowing crossownership could eliminate this growing competition. This does not mean that the present ban *must* be continued or if it is continued, that it must always be maintained. In particular, increasing competition from other substitute services may make it unnecessary. At present three options seem likely: (1) the Commission can attempt to develop a regulatory policy to encourage competitive provision of services even where the facility is owned by a telephone company (the partial separations approach discussed below is an example of such a policy); (2) the Commission can retain its current ban on crossownership but institute more flexible waiver and lease-back arrangements; or (3) the Commission can retain its present ban, but allow individual states to claim jurisdiction over crossownership.

Development of competition in local distribution would reduce the need for crossownership restrictions. The limited number of local two-way options is the fundamental reason for concern over crossownership. Direct Broadcast Satellite or other video services may eliminate any market power over the provision of video services now held by cable; nevertheless they provide no competition with the telephone company in the local loop.

This section has argued that a complete elimination of the crossownership ban would substantially damage the consumer by reducing competition in an already uncompetitive area. The crossownership ban is only one means of encouraging competition. Alternative policies are discussed below. Although these alternatives are rejected for the present, they may be viable after further development of competitive technology.

---

next several years will show whether cable actually does have the potential to offer viable competition to the telephone company. (Naturally this assumes that regulation does not prevent cable systems from competing with telephone companies.)

The options before the Commission are not all equally reversible. If they were, the Commission could afford to experiment with one type of restriction and, if it were unsuccessful, implement another. In fact, it would be far easier for the Commission to reverse itself if it adopted a complete ban on crossownership than if it allowed crossownership and then telephone companies constructed single-wire systems.[55]

D. *Rely on State and Local Governments.*

The earlier chapters of this report argue that many cable concerns are local rather than national. Cable companies serve local markets and are directly subject to local franchise restrictions. The Commission must justify its regulation on the basis of interstate effects. If national concerns cannot be demonstrated, the dangers of crossownership are best left to the local communities or to the states.

Local franchising authorities are affected by many of the dangers involved in telephone provision of cable service. Restricted competition for two-way services is likely to cause local concern. Nevertheless, these local authorities cannot internalize all the costs that are imposed on consumers by crossownership. Concerns facing the nation but not directly affecting local communities include:

---

[55] For a discussion of the problems that can develop when a decision must be made that may be reversed in one direction only (i.e., the Commission can reverse its decision to ban crossownership, but would find it difficult to reverse a decision to allow crossownership), see C. J. Cicchetti and A. M. Freeman III "Option Demand and Consumer Surplus: Further Comments," 85 *Quarterly J. of Economics*, 528-539 (1971): The conclusion of this work is that such decisions should only be made when the evidence points strongly in favor of the irreversible choice. If the irreversible choice seems only slightly superior, and if the passage of time will yield information to make a better choice in the future, it should not be adopted.

—The interstate and intrastate toll ratepayers may have to bear a substantial part of the cost of cable facilities (through the separation and settlements process) if the telephone company is able to attribute cable costs to telephone services. Nationwide rate averaging means that states will bear only a small share of any costs that their individual misallocations puts into the interstate rate base.

—The ability of competitive interstate carriers to survive or grow is likely to be damaged by maintenance of local monopoly. Thus crossownership will affect interstate competition.

Therefore, Commission rules that have the effect of limiting local choice are not necessarily arbitrary decisions to overrule local tastes. Rather, they may be taken to ensure that social costs extending beyond a local area are taken into account.

National policy involvement is conditioned on several factors. If all interstate carriers have access to the local market at non-discriminatory rates and terms, and if costs are allocated properly, state regulation can be relied upon. Total reliance on state or local decisions is extreme. Although reliance on state or local franchisers would allow the Commission to focus on other matters, it would do so at high cost. Because cable is a potentially crucial local loop competitor, we do not believe that this alternative should be chosen at this time. As alternative means of access develop, however, the Commission should consider transfering the responsibility of crossownership regulation to the states. States are concerned about local costs and local monopoly abuse. Therefore even after competitive technologies are nationally available, state governments should retain the authority to ban crossownership if the Commission eventually phases out its own rules.

E. *A Regulatory Approach: Partial Separations*

1. *Introduction*

The Commission can also deal with problems of cross-ownership directly, through regulation. One regulatory approach, partial separations, may be a long run means of allowing crossownership even if local competition does not developed fully. For reasons discussed below, however, we do not believe that separations can be relied on at this time. In the following subsections the partial separations idea is developed and the limits it would place on telephone company behavior are decribed. It is argued that rate-of-return or separate subsidiary requirements are of little benefit once separations is adopted. Major drawbacks of the separations policy are detailed in the final subsection.

2. *Definition of Partial Separations in the Cable-Telephone Context*

Partial separations is a system that requires that the use of most of the cable bandwidth be offered on a "common-carrier" basis. This approach deals with monopoly control over local facilities by allowing non-discrimintory access for all who desire to use cable facilities. Under such a policy, a telephone company could not control local distribution over cable even if it owned the cable. Potential competitors would have some form of access to cable facilities despite telephone ownership.[56]

The policy is termed "partial" because the telephone company is allowed to program some share of total cable programming.

---

[56] This depends on the effectiveness of the separations policy. Section F argues that implementation of separations policy is premature as it would now be impossible to find a solution that is even close to non-discrimination.

Non-discrimination is the key to an effective separations policy. If the Commission cannot enforce non-discriminatory access, separations policy will fail.[57]

3. *The Share of Programming Allowed Under Separations*

Under this approach, a telephone company should not be allowed to program more than some stated *share* of the total available cable programming. If instead the telephone company were limited to programming no more than some *number* of total channels, it would have an incentive to construct too small a system. On the other hand, if the limit were a share of total *capacity*, the telephone company might allow much of the cable capacity to lie idle.[58] These problems will be averted if the telephone company is allowed to program a well defined share of the total used capacity. Such a requirement would encourage it to lease to competitive programmers in order to program more itself.

For a separations policy to be successful, no single programmer should be able to gain a monopoly position. On the other hand, some programming costs can be reduced by being spread over several channels. For this reason neither a very high, nor a very low share limit (for instance a single channel) would be appropriate. A limit in the range 20 to 30 percent for any one carrier on a telephone company-owned system appears reasonable. This level will allow the company to program a number of channels while leaving a substantial share available to potential competitors. If the telephone company were to gain a dominant position in the cable (say

---

[57] A separations policy is regulatory rather than the reverse. A separations policy will involve more regulation than the present ban as a price for eliminating a constraint on telephone company behavior.

[58] It would have these incentives because it could thereby exclude potential users and avoid the purpose of separations policy.

80 percent), it could treat the system as if it were wholly owned from the standpoint of cost-shifting—that is, while it would rather control the entire system, it might be able to engage in join profit maximization and limit competitive entry even though competitors have access to some small share of capacity. If its share were to fall below 5 to 10 percent, it might have little incentive to build a system since it could not take advantage of any special programming advantages that it might have.

The 20-30 percent limit on telephone company programming is not precise. It is unlikely to make much difference whether the highest level is 30 percent or 31 percent. Nevertheless, the higher the level, the greater is the danger from telephone monopoly power. If its allowed share were high, it could leave several potentially profitable video services untapped, and charge monopoly prices for two-way services. Because two-way services require different equipment and may require the potential for a growth in capacity as more customers subscribe, the telephone company could probably encourage potential competitors to use the limited remaining channels for the profitable video alternatives. Setting a lower maximum telephone company share of programming would limit this problem.

4. *Separations Policy and Cost-Shifting*

Separations policy would not eliminate the danger of cost-shifting to avoid telephone rate-of-return regulation, but it might limit it. Separations involves nondiscriminatory charges that are independent of the uses to which cable channels are put.[59] Therefore, fully effective separations policy would eliminate cost-shifting within the cable facility.

In addition, a separations policy can somewhat limit the opportunities for cost-shifting between telephone and

[59] See Chapter 7.

cable facilities. Potential competition with local loop services over cable facilities limits the price that can be charged to telephone users. Thus the need for regulatory control over telephone rates, and the incentives to shift costs would decline.[60] Although the telephone company could increase cable rates to limit this competition, any rate increase would tend to force video programmers as well as two-way cable users off the cable; this would substantially reduce the attractiveness of such a strategy.[61]

5. *The Separate Subsidiary*

In its recent decisions in Computer II and Cellular Radio[62] the Commission relies on a telephone company subsidiary with independent management, capital, and labor to limit cost-shifting. No such separate subsidiary requirement should be applied to a telephone company owned cable system.

We argued in Section I that the most important potential advantages of crossownership come from economies in joint construction and from increased division of labor. Requiring full separation of facilities and eliminating the opportunity for increased specialization of labor would

---

[60] The need for regulatory oversight and the danger of cost-shifting depend on monopoly power. If competition develops, such problems are reduced. Separations policy might allow a form of competition. Because of this, dangers of cost-shifting fall.

[61] Because a wide range of alternatives to video services exist, the demands for cable television channel capacity (at the margin where the high demand channels are already being provided) is likely to be quite elastic. Thus any increase in the price of channel capacity would lead to substantial reduction in television type demand and a consequent loss of revenue. That monopoly power is highly constrained by elastic demand is a basic economic principle.

[62] See Computer II Final Decision, 77 FCC 2d, 308, Computer II Reconsideration, 84 FCC 2d, 1; and Cellular Radio, 78 F.C.C. 2d, 984.

make it impossible for a separate subsidiary to achieve these economies. Thus the separate subsidiary requirement eliminates the major advantages of allowing cross-ownership. On the other hand, a telephone company owned separate cable subsidiary that was not subject to a separations policy could constrain two-way service competition by simply not introducing services that an independent system would, or by charging monopoly rates. Such a subsidiary might also be able to shift some costs to the parent telephone company. A separate subsidiary solves none of the problems of telephone ownership, but does eliminate any potential economies.

The only area where a separate subsidiary might serve a useful function is in programming. The expertise and training required for programming are quite different from those required of telephone managers. Little reduction in division of labor would result from a separate programming subsidiary. On the other hand, little would be gained. While the regulator could look to see whether the subsidiary regularly lost money (implying that it was being accorded an unfair advantage against other cable programmers), careful auditing could fulfill the same purpose, and would be equally necessary under a separate subsidiary. Under a separations policy, it would not be worthwhile to extend much favoritism to telephone company owned programmers.

6. *Need Rate Regulation Be Extended to Telephone Company-Owned Cable Systems?*

Telephone companies may be able to evade rate-of-return regulation through ownership of cable facilities. The crossownership ban prevents this but is not the only possible cure. Rate-of-return regulation could be extended to telephone company owned cable systems. This would limit the scope for telephone cost shifting. Alternatively, a cost manual approach could be used to allo-

cate costs without the use of rate-regulation,[63] or rate-of-return regulation could be abandoned altogether.

Many problems of telephone behavior are caused by rate-of-return regulation. Removing rate-of-return regulation from all basic telephone service, however, is beyond the scope of this study. Extending rate of return regulation to cross-owned cable systems (but not to other cable systems) would extend the defects of rate regulation to a new area,[64] [65] although it would reduce, but not eliminate, the danger of cost-shifting. It would do nothing to reduce foreclosure of competition from independent cable.

---

[63] This is the approach advocated by Duvall and Pelcovits *supra*, in their examination of private line telecommunications services. It is important to realize that Duvall and Pelcovits discuss a market where costs are already joint or common.

[64] The defects of rate-of-return regulation go far beyond the staffing costs of regulatory agencies. The costs of regulation include those costs, the direct costs imposed on the regulated companies to satisfy the data and legal requirements of the regulatory authority, plus the sometimes substantial costs that society as a whole must endure as entrepreneurs divert their genius into discovering means of evading rate-of-return regulation rather than toward socially productive ends.

It is a commonplace observation that regulation leads to perverse incentives. (See Averch and Johnson, *supra*. See also Cornell, Kelley and Greenhalgh, *supra*.) Historically, rate regulation problems have been compounded by one way risk. That is, if the utility overinvested, the plant becomes part of the rate base; underinventment, reflected in inadequate service, is the cause of strong regulatory reaction. The motives are all toward overbuilding—toward providing a "gold plated" system.

It is these fundamental distortions, not the increase in Commission workload, that causes the gravest concern about any move to spread this form of regulation.

[65] Even if rate-of-return regulation were imposed on both cable and telephone company services, the telephone company may still find some incentive for cross-subsidy between telephone and cable facilities because of differences in elasticities of demand between the sectors, (see Averch and Johnson *supra*.) These incentives, however, are far less powerful than where cable profit can escape regulation altogether.

In recent years, the Commission has regulated interstate telephone services on a service basis after allocating costs among the various services. State regulators do not normally make the same forms of cost allocation. Telephone company ownership and operation of cable facilities would require a careful allocation of costs to protect interstate ratepayers from paying costs generated by a telephone-owned cable facility regardless of whether the cable system is to be rate-of-return regulated.

Because this form of cost separations will be required before rate regulation can be implemented, the potential benefits of rate regulation are small. Regulation can impose high costs on consumers and on taxpayers as well as on the regulated entities. Rate regulation, therefore, should not be extended to telephone company owned cable system.

F. *Problems with the Regulatory Approach*

Several rules are essential to limit the ability of telephone companies to monopolize the local access market. These are: (1) the telephone company must be constrained in the amount of programming that it can offer; (2) access to cable must be made available to others, including potential two-way competitors, on a nondiscriminatory basis; and (3) costs must somehow be allocated between cable facilities and telephone facilities in order to limit cost shifting. None of these requirements will be easy to ensure. Indeed, some of the requirements may be contrary to efficiency.

It will be very difficult to determine whether nondiscriminatory access is actually available. While a one-way wideband channel tariff could presumably be devised in a straightforward way, it is difficult to compare this rate with a one-way narrowband channel rate. It will be even more difficult to compare one-way with two-way rates. Because the telephone company can use its own wire-pair facilities for the provision of two-way services, non-

discrimination between two-way narrowband cable users themselves is insufficient to ensure competition on two-way cable facilities.

If two-way cable technology was already used extensively, and available for comparison, the Commission or local regulators could devise some formula to determine the relationship between two-way and one-way bandwidth rates. Such a formula would have to take into account the cost and demand differentials in each case. At present, however, very few cable systems provide two-way services to large numbers of customers. There is nothing close to a technical industry standard(s), and multiple approachs may be developed.

The Commission cannot easily devise a formula to set relative prices for two-way and one-way bandwidth at the current state of technology. Attempts to do so could preclude some efficient technologies, or could lead to wasteful investment in circumventing regulations rather than meeting them.

Over time, cable systems will begin to implement various two-way technologies. Some are already doing so. Once the technologies are understood, the Commission may be in a position to develop prices that are at least relatively non-discriminatory.

Price discrimination is only one form that discrimination might take. The telephone company could also discriminate against the two-way users by requiring these users to use terminal equipment that meets specifications far in excess of those needed to protect other users.[66] Similarly, the telephone company could offer faster interconnection to one-way users, or could impose technical standards that are difficult for the two-way user to meet. Again, these forms of discrimination would be difficult to detect.

---

[66] Such a requirement would violate Part 68 of the Commission's rules. (47 C.F.R. Part 68). Nevertheless, it would be difficult and costly to detect such discrimination.

Even in the long run separations policy is imperfect. Chapter 7 argues that separations policy should not be applied to independent cable systems. Part of the reason is that separations policy prevents efficient cable pricing. This flaw will remain even if the short-run problems with separations in a telephone company owned cable system are managable.

Careful regulation can limit discrimination only if the technology to be used is understood. The costs of this continual regulation, both to the Commission and to franchise authorities, would be high. These regulatory costs and the possibility of limited regulatory effectiveness may make this approach unacceptable even in the long run. Nevertheless, while separations policy must be rejected at this time, we believe that it should be considered as a potentially valuable future Commission policy in dealing with cable-telephone crossownership.

G. *A Continued Ban on Crossownership*

We believe that regulatory tools cannot now solve the problems involved in crossownership between cable and telephone facilities. A continued reliance on the crossownership restriction is necessary. Under the current ban, the cable industry has developed rapidly. Over the past several years rapid growth in cable audiences and programming have been made and new two-way services are being introduced. Cable has expanded rapidly in both urban and rural areas. Moreover, alternative technologies such as direct satellite broadcasting and video-disk/tape players substantially increase the probability that almost every consumer can find supplemental video facilities at some reasonable price. A compelling argument for retaining the current ban, therefore, is that things work quite well under the ban and the potential damage may be great under the alternatives.

Cable is one of the telephone company's very few potential competitors in the provision of local loop access.

No regulatory policy outside of the crossownership prohibition can eliminate the danger of continued telephone control over local loop facilities. On the other hand, further development of competition may reduce the need for any regulatory policy except anti-trust measures. Furthermore, rate regulation gives telephone companies strong incentives to engage in cost-shifting. No regulatory policy outside of crossownership prohibition or the elimination of rate-of-return and entry regulation can completely eliminate this problem.

Telephone companies are allowed to construct cable facilities for lease-back to cable operators. Although a telephone company might be able to use this ability to shift costs or to restrict cable competition, lease-back and waiver standards limit the costs of the ban. The Commission can, and should, be prepared to allow crossownership for experimental and innovative systems. Moreover, the Commission must be prepared to remove the ban if alternative forms of local loop competition become more generally available.[67]

The Commission banned crossownership as the result of several concerns. These concerns have not vanished. Indeed cable now shows greater promise for becoming a competitor in many two-way services than ever before. Therefore the ban should be continued.

H. *General Conclusions*

This Chapter has discussed the rationale for banning crossownership between cable and telephone systems within a service area. A ban has some potentially significant costs, but cooperation between the telephone company and the independent cable franchise holder through

---

[67] Likewise, the Commission should continue its policy of allowing crossownership in rural areas where independent cable service is not viable. The benefits of competition are small if no potential entrants exist.

lease-back arrangements can avoid many of these costs. At the moment the current ban is preferable to Commission withdrawal from crossownership regulation.

We conclude that the arguments against crossownership do overcome the presumption that any firm should be allowed to enter cable if it wishes. Telephone companies are an exception. The twin dangers of cost-shifting and foreclosure of competition combine to make unregulated crossownership unacceptable.

If neither complete deregulation nor state or local regulation can be relied upon, the Commission's remaining alternatives are to continue the crossownership ban or to introduce a regulatory approach that allows crossownership but limits abuses through a partial separations policy. We were unable to develop a workable regulatory approach that addresses the real problems. Although we believe that separations policy shows promise as an eventual solution, it cannot be relied upon at this stage. Therefore, we recommend that the crossownership ban be retained.

We conclude that a continued prohibition of telephone ownership of cable remains essential. This need not be a permanent result. The decision depends critically on the nature of competition in the provision of local loop services. Cable facilities are currently one of a very few ways that the telephone company owned local loop can be circumvented. As such, unregulated cable ownership provides an important opportunity for continuing telephone company control over local distribution.[68] The ban may become redundant with the development of XTEN, non-telephone owned cellular radio, direct satellite communications, or other as yet unforeseen technologies. Likewise, if cable remains almost wholly an entertainment medium, the ban will serve little useful purpose and should be eliminated.

---

[68] See "Comments of Department of Justice in CC Docket 80-767" (Rural Cable-Telco Cross-Ownership) (1981).

If the Commission retains the existing crossownership ban, it should reiterate and amplify its waiver standards. Telephone companies that propose technically innovative systems should be granted limited experimental waivers, even if they cannot demonstrate the current strong cost economies specified in the Commission's Sugar Land decision. The Commission should not stand in the way of innovation. Such a waiver process, and an expanded role for lease-back arrangements, can go a long way toward achieving the most important advantages of crossownership.

It is possible that some states can develop regulatory approaches that will satisfy themselves and the Commission. If a State wishes to implement a separations approach, the Commission should consider allowing it to do so. Because of substantial interstate concerns, the Commission cannot automatically accept any proposal. It could consider allowing some flexibility, especially after several years, when the competitive technologies being developed by the cable industry are better understood.

The basic conclusions developed in this chapter are three.

- The Commission should retain the current crossownership ban.
- The Commission should allow lease-back agreements and rely more fully on the protection of independent cable operators offered by the Pole Connection Act.
- The Commission should entertain experimental telephone waivers that propose innovative cable technologies.

The information gained in these experiments on the development of cable technology and on alternative forms of local competition, will be helpful in a future reevaluation of the crossownership ban.

GAO

United States General Accounting Office

Report to Congressional Requesters

October 1987

TELEPHONE COMMUNICATIONS

Controlling Cross-Subsidy Between Regulated and Competitive Services

[GAO Logo]

United States
General Accounting Office
Washington, D.C. 20548

Resources, Community, and
Economic Development Division

B-229035

October 23, 1987

The Honorable Edward J. Markey
Chairman, Subcommittee on
Telecommunications and Finance
Committee on Energy and Commerce
House of Representatives

The Honorable Mike Synar
House of Representatives

The Honorable Timothy E. Wirth
United States Senate

In response to your requests, this report evaluates the use of accounting controls to prevent cross-subsidization between regulated and nonregulated telephone service and addresses the resources, motivation, and authority of the Federal Communications Commission to police the behavior of the telephone companies if and when they enter new competitive businesses.

As arranged with your offices, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of this letter. At that time, we will send copies to the Chairman, Federal Communications Commission; interested congressional committees and subcommittees; and individual mem-

bers of the Congress, as well as other interested parties. Copies will be made available to others upon request.

A list of major contributors to this report is included in appendix III.

/s/ J. Dexter Peach
J. DEXTER PEACH
Assistant Comptroller General

EXECUTIVE SUMMARY

Purpose

Advances in technology, as well as industry deregulation and restructuring, have resulted in telephone companies seeking to offer competitive telecommunications services in conjunction with their regulated services. The Congress and telephone industry regulators are currently faced with deciding how best to bring new services to the public. Both telephone companies and users can potentially benefit from new competitive services. However, without adequate safeguards and regulatory oversight to ensure that costs are properly allocated, local telephone customers risk subsidizing the competitive services (cross-subsidy) through their telephone bills.

The Federal Communications Commission (FCC) decided in 1986 to permit greater integration of competitive and regulated operations as long as prescribed cost allocation standards and procedures are followed. Congressional requesters asked GAO for information on the background and rationale for FCC's actions, as well as FCC's ability to implement the cost allocation procedures to control cross-subsidy between companies' regulated operations and their competitive ventures, which are nonregulated.

Background

In a series of decisions since 1971, FCC has dealt with the increasing convergence of computer and telecommunications technology by delineating "basic" regulated services and "enhanced" nonregulated services, and setting the conditions under which telephone companies could offer enhanced services using the regulated telephone network. FCC has generally required telephone companies to offer such services through a structurally separate subsidiary, to protect telephone customers from helping to

pay the costs of competitive activities and protect competitors from unfair competition.

In 1986, however, FCC determined that separate subsidiaries were both inefficient and restricted the advance of technology. It adopted a new program of nonstructural safeguards to promote technology and efficient network use, while still addressing ratepayer and competitive concerns. A key nonstructural safeguard that FCC adopted is a process for allocating telephone company costs shared by both regulated and nonregulated operations. Elements of this process include (1) cost allocation standards and accounting procedures, (2) company cost allocation manuals, and (3) annual certified public accountant (CPA) reports attesting that the allocations accurately reflect procedures in the cost manuals. FCC will oversee the entire process and use its own auditors to periodically examine the cost allocations.

Overlying the FCC's efforts to accommodate the integration of regulated and competitive services is the U.S. district court's review of line-of-business restrictions on the seven regional Bell Operating Companies set by the 1984 Consent Decree breaking up the American Telephone and Telegraph Company. The court's September 1987 decision partially relaxed some of the restrictions, meaning some additional integration of regulated and competitive services is likely, although not as much as FCC, the Bell Operating Companies, and others had wanted.

Results in Brief

FCC's actions in prescribing cost allocation standards and requiring cost manuals and annual independent audits are all essential steps of an oversight program to ensure that telephone rates are not subsidizing competitive ventures. FCC expects these measures to provide assurance

to the public that its rules and procedures are being followed consistently and that cost allocations are documented and accurately presented.

However, the unavoidably subjective nature of the cost allocation process and FCC's "public interest" mandate require that it remain involved in overseeing the allocation process and ultimately deciding whether the companies' results are acceptable. FCC plans to audit company records periodically, but at existing staffing levels these audits will be infrequent.

The level of oversight FCC is prepared to provide will not, in GAO's opinion, provide telephone ratepayers or competitors positive assurance that FCC cost allocation rules and procedures are properly controlling cross-subsidy.

Principal Findings

Past Allocation Difficulties

FCC's past cost allocation efforts have been difficult and time-consuming. Reasons for these difficulties include the lack of systematic cost allocation standards and procedures, and the inherent subjectivity, and thus arbitrary nature of the cost allocation process as applied to telephone services sharing common equipment. Economics and accounting both provide guidance on allocating costs, but do not prescribe one single "right" way. Consequently, disagreement is understandable among the affected industry and consumer interests, making it difficult for FCC to arrive at a consensus. In the past FCC justified its requirements for separate subsidiaries by citing the "inherent difficulties" in allocating costs.

FCC's New Regulatory Approach

FCC eliminated the separate subsidiary requirement because it impeded companies from offering new services and therefore imposed costs on the public. FCC deter-

mined that these costs exceeded the benefits that separation had provided by preventing cross-subsidy and other competitive abuses. Still, FCC recognized that some regulatory controls were needed to prevent telephone companies from subsidizing their nonregulated services with regulated revenues or using their control over regulated services to discriminate against competitors.

FCC's new cost allocation program attempts to overcome past problems by developing objective criteria—allocation procedures and cost manuals—to assess compliance. In addition, as a principal oversight tool, FCC is relying heavily on annual reports by CPAs attesting that a company's implementation of cost allocation follows FCC's rules. These reports should help ensure particularly that documentation is adequate and procedures are consistently applied. However, the difficulty in allocating costs of services sharing common facilities and personnel, particularly switching equipment, along with FCC's mandate to determine that regulated telephone rates are "just and reasonable," require ultimately that FCC exercise its own judgment that the telephone company costs are properly allocated.

Limited FCC Oversight

To make these judgments, FCC's periodic audits of telephone companies are crucial, particularly over the next few years, when gaining public acceptance is important. Other means of oversight—including a new computerized data base and access to the CPA's workpapers—are also important as indicators of potential problems that may require FCC to examine company records. FCC will have access to company books and records, and plans to conduct its own audits, but at its existing level of staff and travel resources, these audits will be infrequent. Further, its fiscal year 1988 budget request proposed eliminating 3 of its 15 auditors.

Recommendation

GAO recommends that FCC develop a strategy for providing greater oversight of telephone companies' cost allocations. The key to the strategy is FCC's commitment to allocate sufficient audit staffing and travel funds to permit added field audits.

Agency Comments

As directed by the requesters, GAO did not obtain official comments on a draft of this report. However, GAO discussed the factual information in the report with FCC officials during the course of the work and incorporated their views as appropriate. FCC officials noted that, for the past 2 years, they had requested additional auditors, but that the requests had not survived the budget review process after submission to the Office of Management and Budget.

* * * * *

Chapter 4

FCC's Cost Allocation Rules Will Provide Only Limited Assurance That Cross-Subsidy Is Being Controlled

FCC is in the midst of implementing its new cost allocation rules and procedures—using accounting controls instead of separate subsidiaries—thus, it is impossible to forecast exactly how well these new controls will work. As discussed earlier, there is great concern about the growing potential for carriers to subsidize their competitive activities in the future. Based on our assessment of FCC's progress and plans to date, however, we believe FCC will not be able to provide positive assurance that carrier costs are being properly allocated and cross-subsidy is being controlled. Since FCC's new regulatory program requires more oversight than the structural separation approach, it is essential for public acceptance of the program that FCC be able to provide a high degree of assurance to ratepayers and carrier competitors that cross-subsidies are being properly controlled.

FCC has stated in its joint cost decision that it is critical to oversee how the carriers implement the rules and procedures. We concur that oversight is important, especially in the first few years when it is essential that the carriers implement the new procedures properly, with the benefit of timely feedback from FCC. In addition, because FCC in recent years has actively promoted deregulation in the telecommunications industry, it is essential for FCC to provide assurances to the public that it is serious about fulfilling its regulatory oversight responsibilities. Whether a continued program of intense oversight is necessary in later years may depend on proper guidance and direction initially.

The CPA attestation reports will go a long way toward assuring FCC the new procedures are properly implemented, in particular concerning such aspects as ade-

quacy of carrier documentation and consistency of application from year to year. However, the unavoidably subjective elements contained in (1) the cost allocation process, (2) the CPA attestation, and (3) FCC's mandate to determine that rates are "just and reasonable," require ultimately that FCC exercise its own judgment that the carriers' costs are properly allocated.

FCC's access to carriers' books and records is its main oversight mechanism in making these judgments. Its other means of oversight—tariff review, the ARMIS system, the complaints process, and review of CPA attestation reports—are also important, but these are essentially indicators of potential problems that may lead FCC to audit carriers and ultimately decide if costs are properly allocated.

The basis on which FCC will routinely determine that cost allocations are properly preventing cross-subsidies is questionable. The absence of complaints or other indicators of problems may cause FCC to conclude that no problems exist, but as we discussed in chapter 3, these indicators may not be effective, at least initially. While FCC will certainly investigate major problems if they are brought to its attention, it is also important for FCC to routinely sample carrier books and records to assess compliance and also judge the CPAs' work. We see FCC at present with only the ability to do infrequent reviews of carrier records, given available audit staff and travel funds. Further, FCC's fiscal year 1988 budget request proposed to eliminate three auditor positions.

Judgment Is an Inherent Element of FCC's Cost Allocation Rules

Part of FCC's past problem with cost allocations, as we discussed in chapter 2, has been the inherent subjectivity of the cost allocation process. FCC's new joint cost rules

are an attempt to deal with the problem by specifying procedures and requiring carriers to have cost manuals. Together, these serve as objective means against which FCC and the CPAs can judge compliance. Still, subjective elements will continue to play a major role in the entire process, given the difficulty in objectively allocating the costs of telephone services sharing common equipment, coupled with the judgmental aspects of both the CPA attestation audit and FCC's obligation to see that rates are "just and reasonable."

The public accounting firm, Coopers & Lybrand, in commenting on FCC's joint cost rules, recognized the value of the independent attestation, but concluded that FCC still has the major responsibility for evaluating the entire process. Coopers & Lybrand stated that

> "The use of independent audits will provide the federal regulator with verification that the numerical calculations are accurate and data sources are reasonable, and both reflect the approved cost manual procedures. This type of audit is quite far-reaching and informative as to compliance with cost allocation procedures employed by an individual carrier. However, in such audits, the adequacy of the cost allocation plan is assumed. The independent audit process is not intended to serve as a means to draw parallels or to make qualitative or quantitative judgments on another company's cost allocation manual process. As the [joint cost] Order states, the FCC retains the major burden on determining initial compliance and on the evaluation and monitoring of the process as a whole." [1]

Written comments provided by two other public accounting firms in FCC's joint cost proceeding both recognized

---

[1] *Assessment of Current Status of FCC Cost Accounting Intiatives: CC Docket 86-111*, prepared by Coopers & Lybrand for United States Telecommunications Suppliers Assn., Mar. 1987, p. 17.

the subjective elements involved in making cost allocations. One firm, Price Waterhouse, helped prepare a draft cost allocation manual for Southwestern Bell Telephone Company that was over 100 pages long and contained specific detailed instructions on how to allocate each of Southwestern Bell's various expenses. Despite the detail, however, the manual recognized the subjective nature of cost allocations. For example, the manual states that ". . . no generally acceptable allocation technique has been identified as appropriate in all circumstances." The manual also discussed allocating general overhead expenses (such as officer salaries) on an "intuitively logical manner." [2] Similarly, comments prepared by the accounting firm, Peat, Marwick, Mitchell & Co., setting forth its view on cost accounting methodologies, stated that "There will always be tradeoffs in the selection of an approach, namely precision, reliability, and level of information against the cost of implementation." [3] In this regard, a paper prepared by an economics consulting firm discussing FCC's proposed joint cost rules stated that allocation problems are

> ". . . caused not by accounting abuses but by the arbitrariness of allocations used to divide joint costs, the discretion that must be given to the firm to decide which of several allocators to use, and the ability of the regulated firm to choose resources and technologies that evade the constraints of the costing process." [4]

---

[2] Cost allocation manual prepared by Price Waterhouse, submitted with comments of Southwestern Bell Corp. on Docket 86-111, June 1986, section 2, p. 10.

[3] "Evaluation of Cost Allocation Manuals," prepared by Peat, Marwick, Mitchell & Co., submitted with reply comments of American Telephone and Telegraph Co., on Docket 86-111, July 1986, p. I-8.

[4] *Accounting Separations: A Contradiction in Terms*, by Cornell, Pelcovits & Brenner Economists Inc., Mar. 1986, p. 23.

The attest examination itself will also require the exercise of judgment on the part of the CPA. The American Institute of Certified Public Accountants' *Statement on Standards for Attestation Engagements* is to be followed by CPAs doing attest work. This statement recognizes the role that judgment can play in reaching a conclusion. It says,

> "Competent persons using the same or similar measurement and disclosure criteria ordinarily should be able to obtain materially similar estimates or measurements. However, competent persons will not always reach the same conclusion because (a) such estimates and measurements often require the exercise of considerable professional judgment and (b) a slightly different evaluation of the facts could yield a significant difference in the presentation of a particular assertion." [5]

The statement also says the CPA should consider "materiality" when reporting his conclusion. A CPA's judgment of what is material may well differ from that of an FCC regulatory auditor.

The ultimate exercise of judgment occurs when FCC carries outs its "public interest" responsibility and determines that rates are "just and reasonable." This concept appears to be similar to the concept of "fairness" that was mentioned in chapter 3 as being a fundamental criterion in any allocation process. FCC defined "just and reasonable" in the joint cost order as both (1) protecting ratepayers by assuring rates do not subsidize nonregulated services and (2) promoting savings to the ratepayer from the integration of regulated and nonregulated services.

For example, based on its "public interest" responsibilities FCC could require a carrier to adjust its cost allocations

---

[5] *Statement on Standards for Attestation Engagements*, American Institute of Certified Public Accountants, Mar. 1986, p. 10.

if, in its judgment, the result would be more nonregulated services being offered. In justifying its Computer III decision, FCC cited such a service, called Custom Calling II, that no carrier had offered while structural separation requirements were in effect.

Assurance Is the Key to Acceptance of FCC's New Regulatory Program

It is essential that FCC create public confidence in its new regulatory program to ensure both telephone ratepayers and firms competing with carriers that a carrier's regulated services do not subsidize its nonregulated activities. Assurance is particularly important over the next few years to counter the uncertainty and anxiety that will exist over (1) how both the carriers and competitors will behave under a new set of regulatory ground rules and (2) how effectively FCC will oversee the program. As time goes by, the need for assurance may lessen as everyone's comfort level with the program increases.

The Department of Justice consultant's report, *The Geodesic Network*, discussed both the potential and likelihood of cross-subsidy occurring if carriers entered a number of nonregulated telecommunications markets. The report generally found moderate to high percentages of costs potentially shiftable from nonregulated to regulated operations. However, the report generally did not see any cross-subsidy having much of an immediate impact on regulated rates because of the small size of the nonregulated activities compared with regulated operations.

Cross-subsidy is not a large problem at present but the potential is great. Where a firm operates in two markets —one is monopolizes and another with many competitors —it has an incentive to subsidize the competitive mar-

kets by undercharging for competitive services and/or shifting costs to the captive monopoly market. Cross-subsidy has not been a large problem to this point because carriers' relatively small investments in competitive markets dilute any impact on telephone rates. The potential will become greater in the future for a number of reasons. First, carriers are increasingly investing in competitive ventures. Second, the recent decision by the divestiture court relaxed some restrictions on BOCs' investment in competitive areas. Although the BOCs did not get all the relief they wanted, the court opened new areas e.g., the ability to provide information service transmission. Third, FCC's Computer III regulatory scheme allows monopoly and competitive operations on an integrated basis making cross-subsidy more difficult to detect.

The Justice consultant's report presented a hypothetical example of the potential cross-subsidy due to cost shifting by a carrier offering nonregulated electronic mail service.[6] Two-thirds of the costs of an electronic mail operation could be potentially shiftable to similar cost categories in regulated operations, the report said. The example showed that $200 million, or 11 percent, of a carrier's regulated costs fall into categories potentially shared with an electronic mail operation. If there was a 10-percent increase in these $200 million of regulated costs due to cross-subsidy, there would be only a 1-percent increase in total carrier regulated costs, a small impact on regulated rates. However, this same 10-percent increase on the regulated side due to cost shifting would yield a corresponding decrease of 7 percent in nonregu-

---

[6] Electronic mail service is defined as a computer-based method of transmitting information that involves composing messages on a computer terminal, transmitting them electronically, and storing them in computer storage for later retrieval by a recipient.

lated costs, a significant impact on competitive operations.[7]

FCC's requirement that each CPA attestation report provide a "positive" level of assurance rather than a "negative" level of assurance will provide FCC a greater degree of assurance. However, FCC's own oversight of the cost allocation program will provide only a "negative" assurance that cross-subsidy is not occurring because of the limited FCC staff available to examine carrier books and records.

Limited FCC Staffing Will Reduce the Level of Assurance

Adequate FCC resources for overseeing and enforcing cost allocation rules has been a concern both in past FCC actions related to Computer II and also in connection with Computer III and the joint cost rules. In the Computer II decision and related proceedings, FCC indicated that among the reasons structural separation was preferable to accounting controls alone was that such controls were more difficult to implement, and could require added staff and more intrusion in monitoring efforts. Similar concerns over FCC's oversight capability were raised in June 1986 by several commenters in the joint cost proceeding. In particular, the Department of Justice recognized the benefits of requiring annual CPA audits but still called for a "vigorous" FCC audit program focusing on both problem areas and randomly selected companies. Justice comments expressed concern

> ". . . that at present the Commission does not have a sufficient number of auditors to take on the increased responsibilities resulting from this proceed-

---

[7] *The Geodesic Network, 1987 Report on Competition in the Telephone Industry*, Consultant's Report to the U.S. Department of Justice, Jan. 1987, pp. 11.16-11.18.

> ing. The failure to devote sufficient resources to the audit process will reduce any prophylactic program, no matter how sound in theory or principle, to a sham that deceives rather than protects ratepayers and state regulators. Thus, we cannot stress too strongly the importance of the commission allocating adequate resources to enforce the accounting rules before separate subsidiary requirements are eliminated." [8]

The North American Telecommunications Association said that if FCC is to fulfill its auditing objectives, it must immediately seek staff reassignment within FCC and pursue additional funding for the auditing functions.[9] In rebuttal, FCC said that it was committed to fulfilling this oversight responsibility, but did not provide any specifics on its plans to audit carriers. FCC's Common Carrier Bureau staff informed us that they are optimistic about preventing cross-subsidy and cited the elements of its program to oversee the cost allocations, i.e., CPA attestation reports, the ARMIS system, and FCC audits.

Requests for Increased Audit Staff Denied

Since fiscal year 1983, overall staffing of the Accounting and Audits Division has more than doubled, with Audits Branch staff increasing by eight auditors in the post-divestiture year of 1985. For fiscal year 1987, the Division has approximately 67 persons, including 22 in the Audits Branch. Of the 22 staff members, the branch has 15 persons listed as auditors, while the remainder are in management, legal, and support categories. FCC has requested additional auditors in its recent budget pro-

---

[8] Comments of the U.S. Department of Justice on Docket 86-111, June 1986, p. 36.

[9] Comments of the North American Telecommunications Assn., on Docket 86-111, June 1986, pp. 38 and 39.

posals to the Office of Management and Budget (OMB), but increases have not been approved. In fact, FCC's fiscal year 1988 congressional budget submission called for a decrease of three auditors.

For fiscal years 1987 and 1988, FCC's proposals to OMB were for an added nine and three auditors, respectively. However, the FCC congressional budget submissions asked for no additional auditors in 1987 and the reduction of three positions in 1988. The justifications for the increases were similar: The Commission is increasingly relying on auditing to protect ratepayers from bearing costs that are not associated with regulated services and to ensure fairness in the marketplace. Other factors contribtuing to an increase in audit requirements included an increase in the number of regulated carriers as a result of the AT&T divestiture, the increased movement of such regulated companies into unregulated businesses, revisions of the manual used in separating costs between interstate and intrastate services, the monitoring of Computer II and III compliance, the implementation of the revised Uniform System of Accounts, and, of course, the implementation of the carriers' cost allocation manuals under the joint cost decision's standards.

To justify its proposal for the additional auditors for 1988, FCC's Common Carrier Bureau said that it had identified 256 areas [10] in the operations of the major carriers that it had responsibility for auditing on a routine basis. The Bureau acknowledged, however, that resources were unavailable to perform these audits annually. Instead, according to the Bureau, a more reasonable plan would be to spread out the audits in order to control costs

[10] FCC identified the 256 areas requiring audit attention in the 20 operating companies owned by the regional BOCs, the 7 regional BOCs themselves, and 2 other major independent telephone companies—GTE and United Telecom. The regulatory areas included were USOA, separations process, access charges, joint costs, Computer III, and depreciation rates.

while still giving the Commission some assurance that carriers are complying with rules. Its proposal was to conduct about 32 audits a year, meaning FCC would audit each of the 256 areas once every 8 years. FCC also calculated that on the average this level of effort would allow it an audit presence at most of the major carriers once every other year.

Because FCC's requests for more auditors in each of its past two budget proposals have not survived OMB review, they have not been included in the congressional budget submissions. Reasons cited were to cut budget and alternatives to in-house auditing, i.e., the independent CPA reports.

While FCC had requested increased staff to allow it to conduct 32 audits a year, we noted in chapter 3 that in recent years it had conducted between 9 and 18 audits annually. If an annual level of 16 audits per year with present staff is assumed, FCC would examine each of its audit areas at the major carriers or holding companies only once every 16 years. With the further staffing reduction requested for fiscal 1988, the interval between audits increases even further. While FCC has the discretion to prioritize its audit areas and thus to audit the joint cost allocations more frequently than every 16 years, to do so would short-change its other audit responsibilities, such as the USOA financial reports, separations process, depreciation rates, and access charges.

It is conceivable that FCC auditors, being able to rely on the work conducted by CPAs, may be able to conduct their own audits more quickly and thus increase their productivity even with fewer auditors. However, this is not likely at current budget levels, since FCC staff said that a major constraint on their audit capability is travel funds with which to visit the carriers' offices. Bureau officials reported that only $34,000 had been allotted for audit travel in fiscal 1986 and $32,000 will have been

spent on audit staff travel in fiscal 1987. FCC had unsuccessfully proposed a $184,000 increase to OMB for 1987 for the existing and proposed staff. FCC's fiscal 1988 congressional budget submisison, which is still pending, would result in an increase of $35,000 for Common Carrier Bureau travel. If approved, FCC officials said that the Audits Branch will receive some of this increase.

Statements by FCC officials regarding staffing have been inconsistent. In February 1987, then FCC Chairman Fowler defended the proposed FCC cut of three auditors before the Senate Appropriations Committee. He said that

> "As the regulated telephone companies provide us with independent detailed audits of their operations, we believe we can eliminate one of the audit teams we presently have without adversely affecting our regulatory responsibilities." [11]

Previously, at the December 1986 meeting when the Commisison adopted the joint cost rules, Commissioner Mimi Dawson told her fellow commissioners that this effort is "an area where we desperately need resources. Without this, the strides we've made won't be able to move forward."

Conclusions

The actions FCC has taken in prescribing cost allocation standards, requiring FCC-approved cost manuals, and requiring annual CPA attestation reports are essential steps in implementing a program of accounting controls to guard against cross-subsidy. FCC expects these measures to help overcome problems encountered in its past cost allocation activities, which we discussed in chapter 2. Together, FCC expects these measures to go far towards

---

[11] Testimony of Mark S. Fowler before the Subcommittee on Commerce, Justice, State, the Judiciary, and Related Agencies, Senate Committee on Appropriations, Feb. 1987.

providing assurance that its rules and procedures are being followed consistently and that the carriers' cost allocations are adequately documented and accurately prepared. However, FCC still has a major role to play in overseeing the allocation process and ultimately accepting the carriers' results, given the subjective nature of the process and FCC's "public interest" mandate.

FCC is embarking on a new regulatory program designed to be less restrictive on carriers' activities but that paradoxically may require a greater degree of FCC oversight. FCC has said that it is committed to fulfilling its oversight responsibility, but also has proposed in its congressional budget submission to reduce its audit staff. We share Justice's concern over the need for adequate resources to ensure the integrity of the entire program.

FCC plans to audit carrier records periodically, but at existing staffing and auditing levels these audits will be infrequent, conceivably once every 16 years. At this staffing level, FCC's substantive role may be limited to responding to complaints or problems brought to its attention, but as we noted in chapter 3, the complaints process FCC has relied on to oversee carriers in the past may not work well due to restrictions on public availability of data on carriers' nonregulated activities.

Overall, the level of oversight we see FCC prepared to provide will not, in our opinion, ultimately provide telephone ratepayers or carrier competitors positive assurance that FCC's joint cost rules will guard against cross-subsidy. Such assurance is important in the future with the growth in carriers' competitive ventures, the loosening of restrictions on their entry into more of these ventures, and the increased potential for undetected cross-subsidy in the absence of structural separation requirements.

FCC needs to match its stated intent with plans and resource commitments to assure that it can perform its

oversight role in a timely and thorough fashion. It would be a small consolation for a business that tried unsuccessfully to compete with a regulated carrier to learn from FCC years later that costs had been misallocated, thus hurting its ability to compete. The telephone ratepayers need more immediate assurance as well that allocations are being done fairly.

We cannot say exactly how often FCC should audit or whether the absence of audits will result in undetected cross-subsidy. Certainly the absence of audits increases the risk that cross-subsidy will occur. As we noted in chapter 3, past FCC audits have not resulted in findings of major cost misallocations, so additional resources cannot automatically be expected to result in savings to the ratepayer. However, as we have pointed out, the potential for cross-subsidy is great given the competitive and regulatory environment. An aggressive program of carrier audits by FCC, building on the annual CPA attestation reports, will help create public confidence in the program and send a message to carriers that they can expect FCC to be closely monitoring their activities, at least initially, to make sure they get started properly.

Recommendation to the Chairman,
Federal Communications Commission

We recommend that FCC develop a strategy for providing greater levels of oversight and assurance that carriers are properly implementing its cost allocation procedures. The key to the immediate success of such a strategy or plan is FCC's commitment to allocate sufficient audit staff and travel funds, obtained either by reallocation of current FCC resources or through additional funding.

Elements of a successful strategy should include plans for periodically examining both carrier records and the workpapers supporting the CPA attestation reports. In addition, a strategy should incorporate the flexibility to investi-

gate problem areas identified through the ARMIS system, tariff review, and other means, as well as auditing carriers selected at random. FCC will have to set priorities, since it will likely face continued resource constraints. However, with the ARMIS system and greater audit coverage provided by the CPAS, FCC may ultimately be able to develop alternative review and audit techniques less resource-intensive than its traditional full-scale audits. Also, less frequent audits may be needed once the carriers have become used to the cost allocation procedures and FCC has completed an audit cycle.

LICENSE AGREEMENT FOR POLE ATTACHMENTS AND/OR CONDUIT OCCUPANCY IN THE COUNTIES OF DICKENSON, WISE AND LEE AND IN THE CITIES AND TOWN GEOGRAPHICALLY LOCATED THEREIN.

DATED September 1, 1992

BETWEEN

THE CHESAPEAKE AND POTOMAC TELEPHONE COMPANY OF VIRGINIA
(LICENSOR)

AND

CENTURY MOUNTAIN CORPORATION
(LICENSEE)

ARTICLE VIII

MAKE-READY WORK

A) Poles, Anchors, Guys

1) When an application for attachment to a pole, anchor or utilization of an anchor/guy strand is submitted by Licensee, a prelicense survey will be required to determine the existing adequacy of the pole, anchor, and/or guy to accommodate Licensee's communications facilities. Utilization of the existing available capacity of an anchor/guy strand, when such utilization does not result in a reduction of the holding capacity below the level normally required by the Licensor for safety or other purposes will be permitted at the option of the Licensor and upon agreement by the Licensee to payment of the charges as specified in APPENDIX I.

2) The field inspection portion of the prelicense survey, which requires the visual inspection of existing poles, anchors and guy strands, may be performed by the Licensor or Licensee (with optional participation by joint user and/or Licensee). The administrative processing portion of the prelicense survey, which includes the processing of the application, the preparation of the make-ready work orders, the coordination of work requirements and schedules with joint users and other attachees and the random field verification of field inspection results data developed and furnished to the Licensor by the Licensee will be performed by the Licensor.

(a) When the Licensor performs any portion of the prelicense survey, the Licensor will ad-

vise in writing of the estimated charges that will apply and receive written authorization from the Licensee before undertaking any portion of the prelicense survey (Appendix III, Form B-1).

(b) When the Licensee performs the field inspection portion of the prelicense survey the field inspection results data will be furnished to the Licensor in a format specified by the Licensor and according to standards of accuracy and completeness satisfactory to the Licensor. In view of Licensor's common carrier obligations to maintain safe adequate service, Licensor retains the right to redo the field inspection portion of the prelicense survey if in the sole judgment of the Licensor the data furnished by the Licensee does not comply with the performance standards as prescribed by the Licensor. The Licensee shall pay the Licensor for the total expense incurred by the Licensor to redo the field inspection.

3) Licensor reserves the right to refuse to grant a license for attachment to a pole or anchor, or utilization of an anchor/guy strand when Licensor determines that the available capacity on such pole, anchor and/or guy strand is required for its exclusive use or that of a joint user or governmental entity with pole attachment rights and that the pole, anchor, or guy strand may not reasonably be rearranged or replaced to accommodate Licensee's communication facilities.

4) In the event Licensor determines that a pole and/or anchor to which Licensee desires to attach or an anchor/guy strand which Licensee desires to utilize is inadequate or otherwise needs rearrangement of the existing facilities thereon to accom-

modate the Licensee's communications facilities, Licensor will advise the Licensee in writing of the estimated make-ready charges that will apply (Form B-1).

Licensee shall have 90 days from the receipt of Form B-1 to indicate its written authorization for completion of the required make-ready work and acceptance of the resulting charges. However, if Licensor receives a request from an additional licensee for attachment to a pole or anchor, or utilization of an anchor/guy strand for which a Form B-1 has been sent to an initial licensee, the initial licensee must authorize completion of the pending make-ready work and resulting charges within 15 days after the receipt of written notification from Licensor of the additional attachment request or until the end of the aforementioned 90 days notification period, whichever period of time is shorter.

5) Make-ready work will be performed by the Licensor following receipt of the required written authorization and advance payment from the Licensee. Licensee shall pay the Licensor for all make-ready work completed in accordance with the provisions of this Agreement and Licensee shall make arrangements with the owners of other facilities attached to such poles and/or anchors regarding reimbursement for any expense incurred by them in transferring or rearranging their facilities to make such attachment accommodations available. Licensee shall not be entitled to any monies paid to the Licensor for pole, anchor or guy strand replacements or for rearrangement of facilities on a pole or anchor by reason of the use by the Licensor, joint user, governmental entity or other authorized licensees of

any additional capacity resulting from such replacement or rearrangement.

6) Should Licensor, joint user or governmental entity having pole, anchor or anchor/guy strand accommodation rights, for its own service requirements, need to attach additional facilities to any number of poles or anchors to which Licensee is attached or avail itself of the holding capacity of an anchor/guy strand being utilized by the Licensee, Licensee will either rearrange its facilities on the pole or anchor or transfer them to a replacement pole or anchor, as determined by Licensor so that the additional facilities of Licensor, joint user or governmental entity may be accommodated. The cost of such rearrangement and/or transfer will be at the sole expense of the Licensee. If Licensee does not rearrange or transfer its communications facilities within 60 days after receipt of written notice from Licensor requesting such rearrangement or transfer. Licensor or joint user may perform or have performed such rearrangement or transfer without liability on the part of Licensor or joint user and Licensee shall be liable for the full costs thereof.

7) License applications received by Licensor from two or more licensees for attachment to the same pole, anchor, or utilization of the same anchor/guy strand will be processed by Licensor in accordance with the procedures detailed in APPENDIX II.

8) Whenever it is necessary for Licensor to replace its pole to accommodate Licensee's communications facilities, Licensor will grant Licensee the option where possible, and where possible and acceptable to joint user, to become the owner of

the pole and its associated guys and/or anchors, upon payment of all replacement costs on a fully installed basis. This option is subject to the further conditions that:

(a) Licensee grants Licensor and any existing joint user or authorized attachee the right to attach their respective facilities to such replacement pole and/or associated anchor upon the same terms and conditions as set forth in this Agreement, and,

(b) that any governmental entity having attachment rights to said pole and associated anchor shall be granted similar attachment rights under the same terms and conditions as apply to the pole being replaced.

Should Licensee exercise this option and become the owner of the pole and associated guy strands and/or anchors, it agrees to maintain the pole and associated guy strands and/or anchors in a safe and serviceable condition for attachment of Licensor and joint user facilities for as long as licensee owns an interest in the pole.

B) Conduit System

1) When an application for conduit occupancy is submitted by the Licensee a prelicense survey by the Licensor will be required to determine the availability of the conduit system to accommodate Licensee's communications facilities. Licensor will advise the Licensee in writing of the estimated charges that will apply for such prelicense survey and receive written authorization from the Licensee before undertaking such a survey (Form B-1). A representative of the Licensee may ac-

company the Licensor's representative on the field inspection portion of such prelicense survey.

2) The Licensor retains the right, in its sole judgment, to determine the availability of space in a conduit system. In the event of the Licensor determines that rearrangement of the existing facilities in the conduct system is required before Licensor's conduct system need, for its own service requirements, any of the conduit capacity in writing of the estimated make-ready charges that will apply for such rearrangement work (Form B-1).

   Licensee shall have 90 days from the receipt of Form B-1 to indicate its authorization for completion of the required make-ready work and acceptance of the resulting charges.

3) Should Licensor or any governmental entity with whom Licensor has ~~an~~ agreement granting such entity priority access to and/or occupancy of Licensor's conduct system need, for its own service requirements, any of the conduit capacity occupied by Licensee's communications facilities, and Licensee's communication facilities can be accommodated otherwise in Licensor's conduit system, Licensee shall be required to rearrange its communications facilities in the manner designated by the Licensor and at the expense of Licensee. If Licensee has not so rearranged its communications facilities within 60 days of receipt of written notice from Licensor, Licensor may perform or have performed such rearrangement without any liability on the part of the Licensor and Licensee shall be liable for the full costs thereof.

C) In performing all make-ready work to accommodate Licensee's communications facilities, Licensor will

endeavor to include such work in its normal work load schedule.

ARTICLE IX

CONSTRUCTION, MAINTENANCE AND REMOVAL OF COMMUNICATIONS FACILITIES

A) Licensee shall, at its own expense, construct and maintain its communications facilities on poles and/or anchors, and in conduit systems covered by this Agreement in a safe condition and in a manner acceptable to Licensor, so as not to physically conflict or electrically interfere with the facilities attached thereon or placed therein by the Licensor, joint users, or other authorized licensees.

B) Licensor shall specify the point of attachment on each pole or anchor to be occupied by Licensee's communications facilities. Where communications facilities of more than one licensee are involved. Licensor will attempt to the extent practical, to designate the same relative position on each pole or anchor for each licensee's communications facilities.

C) Licensee shall notify the Licensor in writing at least 30 days before adding to, relocating, replacing or otherwise modifying its facilities attached to a pole and/or anchor where additional space or holding capacity may be required on either a temporary or permanent basis.

D) The Licensee must obtain prior written authorization from the Licensor approving of the work and the party performing such work before the Licensee shall install, remove, or provide maintenance of its communications facilities in any of Licensor's conduit systems. Licensor shall not withhold such authorization without good cause. Licensor retains the right

to specify what, if any, work shall be performed by Licensor at Licensee's expense.

E) In each instance where Licensee's communications facilities are to be placed in Licensor's conduit system, Licensor shall designate the particular duct(s) to be occupied, the location and manner in which Licensee's communications facilities will enter and exit Licensor's conduit system and the specific location and manner of installation for any associated equipment which is permitted by Licensor to occupy the conduit system. Licensor reserves the right to exclude or limit the type, number and size of Licensee's communications facilities which may be placed in Licensor's conduit system.

F) Licensor's manholes shall be opened only as permitted by Licensor's authorized employees or agents. Licensee shall be responsible for obtaining any necessary authorization from appropriate authorities to open manholes and conduct work operations therein. Licensee's employees, agents or contractors will be permitted to enter or work in Licensor's manholes only when an authorized employee or agent or Licensor is present or prior written authorization waiving this requirement is granted by the Licensor. Licensor's said employee or agent shall have the authority to suspend Licensee's work operations in and around Licensor's manholes if, in the sole discretion of said employee or agent any hazardous conditions arise or any unsafe practices are being followed by Licensee's employees, agents, or contractors. Licensee agrees to pay Licensor the charges, as determined in accordance with the terms and conditions of APPENDIX I, for having Licensor's employee or agent present when Licensee's work is being done in and around Licensor's manholes. The presence of Licensor's authorized employee or agent shall not relieve Licensee of its responsibility to conduct all

of its work operations in and around Licensor's manholes in a safe and workmanlike manner, in accordance with the terms of this Agreement.

G) Licensee, at its expense will remove its communications facilities from poles, anchors, or portions of a conduit system within 60 days after:

(1) termination of the license covering such attachment or conduit occupancy; or

(2) the date Licensee replaces its existing facilities on a pole with the placement of substitute facilities on the same pole or another pole, or replaces its existing facilities in one duct with the placement of substitute facilities in another duct.

Licensee shall remain liable for and pay to the Licensor all fees and charges pursuant to provisions of this Agreement until all of Licensee's facilities are physically removed from such poles, anchors and portions of conduit systems.

If Licensee fails to remove its facilities within the specified period, Licensor shall have the right to remove such facilities at Licensee's expense and without any liability on the part of the Licensor for damage to such facilities or without any liability for any interruption of Licensee's services.

When Licensee's communications facilities are removed from a pole, anchor or conduit system, no reattachment to the same pole or anchor or replacement in the same portion of a conduit system shall be made until:

(1) The Licensee has first complied with all of the provisions of this Agreement as though no such pole or anchor attachment or conduit occupancy had previously been made, and

(2) All outstanding charges due Licensor for such previous attachment and/or occupancy have been paid in full.

Licensee shall advise Licensor in writing as to the date on which the removal of its communications facilities from each pole, anchor, and/or portion of conduit system has been completed.

ARTICLE X

TERMINATION OF LICENSES

A) Any license issued under this Agreement shall automatically terminate when Licensee ceases to have authority to construct and operate its communications facilities on public or private property at the location of the particular pole, anchor, guy strand or portion of conduit system covered by the license.

B) Licensee may at any time terminate its license with respect to the attachment to a pole or anchor, utilization of a anchor/guy strand or occupancy of a portion of conduit system and remove its communications facilities by giving Licensor written notice of such intention (Forms E & F). Once Licensee's communications facilities have been removed they shall not be reattached to such pole or anchor, utilize such anchor/guy strand or occupy the same portion of a conduit system until Licensee has complied with all provisions of this Agreement as though no previous license has been issued.

* * * * *

ARTICLE XX

TERM OF AGREEMENT

A) Unless sooner terminated as herein provided, this Agreement shall continue in effect for a term of 1 year from the date hereof, and thereafter until

either party hereto terminates this agreement by giving the other party at least six months prior written notice thereof. Such six months notice of termination may be given to take effect at the end of the original 1 year period or thereafter.

B) Termination of this Agreement or any licenses issued hereunder shall not affect Licensee's liabilities and obligations incurred hereunder prior to the effective date of such termination.

* * * * *

APPENDIX I

SCHEDULE OF FEES AND CHARGES

THIS APPENDIX I, effective as of September 1, 1992, is an integral part of the License Agreement between THE CHESAPEAKE AND POTOMAC TELEPHONE COMPANY OF VIRGINIA (Licensor) and CENTURY MOUNTAIN CORPORATION. (Licensee), dated September 1, 1992 and contains the fees and charges governing the use of Licensor's poles, anchors, guy strands and conduit system by Licensee's communications facilities.

A) *Attachment, Utilization, and Occupancy Fees*

1) *General*

a) Attachment, utilization, and occupancy fees commence on the first day of the calendar month following the date the license is issued for such attachment, utilization or occupancy. Such fees cease as of the final day of the calendar month preceding the month in which the attachment or occupancy is physically removed or the utilization is discontinued.

b) A one month minimum charge is applicable for all attachment, utilization and occupancy accommodations.

c) Fees shall be payable semi-annually in advance on the first day of January and July.

d) The total attachment, utilization and occupancy fees due hereunder, shall be based upon the number of poles, anchors, guy strands and duct feet of conduit for which licenses have been issued before the first day of December and the first day of June each year. Each semi-annual payment shall include

a proration of the monthly attachment, utilization and occupancy charges applicable for attachments, utilizations or occupancy initially authorized by the Licensor during the preceding six (6) month period.

2) *Fees*

Pole, Anchor, and/or Anchor/Guy Strand Accommodations — *Semi-Annual Fee*

a) Per pole attached — *$2.23

This fee is developed in accordance with the F.C.C. ruling in Winchester TV Cable Company vs. The Chesapeake and Potomac Telephone Company of Virginia, File No. PA-81-0045 using historical data from The Chesapeake and Potomac Telephone Company of Virginia. However, this ruling is under consideration by the F.C.C. and this fee may be adjusted to conform to any amended ruling.

Conduit Occupancy Accommodations — *Annual Fee*

b) Per foot of duct occupied

1.) Northern Virginia* — $5.25

2.) All other areas — $3.00

*Northern Virginia is defined as:
Arlington, Alexandria, Falls Church, McLean, Fairfax and Vienna.

c) For the purpose of determining the duct feet chargeable the duct considered occupied shall be measured from the:

(i) center to center of adjacent manholes, or

(ii) center of manhole to the end of a duct not terminated in a manhole.

B) *Charges*

1) *Computation*

Charges for all work performed by the Licensor or by its authorized representative in connection with the furnishing of pole, anchor, guy strand and conduit system accommodations as covered by this Agreement shall be based upon the full cost, plus 15% of such amount, to the Licensor for performance of such work. Such charges will apply for, but not be limited to, prelicense survey, make-ready work, inspection and removal of Licensee's communications facilities and supervision, at the option of the Licensor, of Licensee performed work in and around the immediate vicinity of a conduit system and poles.

2) *Pole, anchor and/or guy strand replacements*

The charge for replacement of a pole, anchor or guy strand required to accommodate Licensee's communications facilities, in accordance with ARTICLE VIII, A)8) shall be based on Licensor's fully installed costs less salvage value, if any.

C) *Payment Date*

Failure to pay all fees and charges within 30 days after presentment of the bill therefore or on the specified date, whichever is later, shall constitute a default of this Agreement.

CENTURY MOUNTAIN CORPORATION

By: /s/ [Illegible]

Its: Senior Vice President

THE CHESAPEAKE AND POTOMAC TELEPHONE COMPANY OF VIRGINIA

By: /s/ [Illegible]

Its: President & C.E.O.

GAO

United States General Accounting Office

Report to Congressional Requesters

February 1993

TELECOMMUNICATIONS

FCC's Oversight Efforts to Control Cross-Subsidization

[GAO Logo]

United States
General Accounting Office
Washington, D.C. 20548

Resources, Community, and
Economic Development Division

B-229035

February 3, 1993

The Honorable Mike Synar
House of Representatives

The Honorable Edward J. Markey
House of Representatives

Advances in technology and deregulation in the telecommunications industry have led to the evolution of companies (carriers) that provide both regulated and unregulated telecommunications services. Regulated services include basic interstate telephone service, and unregulated services include technologies, such as voice mail and electronic mail, that transmit computerized information over telephone lines. If carriers' costs for these two types of services are not properly allocated, customers of regulated telephone services (ratepayers) may be charged for some of the costs of the unregulated services. Such improper cost allocation is known as cross-subsidization.

In 1987, we reported that the Federal Communications Commisison (FCC) had not assigned enough staff to monitor carriers' cost allocations to protect ratepayers from cross-subsidization.[1] Specifically, we reported that at the then existing staffing level, FCC would be able to

[1] *Telephone Communications Controlling Cross-Subsidy Between Regulated and Competitive Services* (GAO/RCED-88-34, Oct. 23, 1987).

examine audit areas, such as time reporting and affiliate transactions, at the major carriers only once every 16 years. We recommended that FCC develop a strategy for increasing its oversight of carriers' cost allocations, emphasizing the importance of FCC's providing enough funds for personnel and travel to permit additional on-site audits. As requested, this report reviews FCC's implementation of (1) our recommendation to increase on-site audits of carriers' cost allocations and (2) certain accounting safeguards established after 1987 to protect ratepayers from cross-subsidization, including audits of carriers' cost allocations performed for the carriers by certified public accounting (CPA) firms, FCC's reviews of these audits, and a computerized system for maintaining carriers' cost and revenue data known as the Automated Reporting Management Information System (ARMIS).

Results in Brief

While FCC has submitted budget proposals requesting additional auditors several times since 1987, no additional positions have been allocated to the on-site audit function. For fiscal years 1990, 1991, 1992, and 1993, FCC asked the Office of Management and Budget (OMB) for 3, 3, 21, and 10 additional auditors, respectively. However, OMB asked the Congress for only three additional FCC auditors for 1990 and 1992 and did not ask for any additional auditors for 1991 and 1993. In the 1990 and 1991 budgets, the Congress approved funds that allowed FCC to increase its staffing level, but no additional positions were allocated to the on-site audit function.

In fact, on-site audit staff have declined since 1987, while the staff's work load has increased by 35 percent since the implementation of FCC's accounting safeguards. As of September 1992, the FCC staff of 14 auditors could, on average, cover the highest-priority audit areas once every 11 years and all audit areas once every 18 years. This level of coverage is inadequate because FCC cannot im-

pose any fines or penalties more than 5 years after a cost misallocation has occurred. Consequently, this staffing level cannot provide positive assurance that ratepayers are protected from cross-subsidization. Increasing the FCC staffing level, along with the appropriate travel funds, would have little or no effect on the federal budget because the government would be reimbursed for its on-site audits and reviews of CPA audits through fees FCC is authorized to collect from carriers.

Since 1987, FCC has established a number of additional safeguards that complement its on-site audits. Though useful, these safeguards have not detected all cases of cross-subsidization. CPA audits have extended FCC's audit coverage, but FCC auditors have found that they have often not been conducted in accordance with FCC guidance. Also, the FCC audit staffing level has not permitted reviews of all CPAs' audit workpapers and reports. Although ARMIS helped FCC to firmly identify one cross-subsidy problem, the system generally does not contain sufficiently precise and complete data to generate the comparisons of carriers' accounts that would allow FCC to readily identify potential cross-subsidy violations.

FCC auditors, through on-site audits, continue to detect instances of cross-subsidy that the other safeguards have not identified. For example, FCC's on-site audits uncovered cost misallocations totaling over $300 million that neither CPA audits nor FCC's reviews of the audits had found. While the other safeguards have limitations, FCC is studying ways to make carriers' cost allocation manuals uniform, which should increase the usefulness of the ARMIS data. Also, FCC has required CPA audits to implement further changes to improve compliance with FCC guidelines. However, on-site audits have demonstrated their effectiveness, and we continue to believe that additional on-site audit coverage is necessary to protect ratepayers' interests.

Background

During the 1960s, telephone and computer technologies became increasingly interdependent. Although FCC had regulated traditional interstate telecommunications since the 1930s, it did not control the new activities that delivered data-processing services over telephone lines. In 1980, FCC issued a decision that created a regulatory distinction between basic communications services and "enhanced" services, such as voice mail and electronic mail. Under this decision, enhanced services were not regulated and "customer premises equipment" (devices located on customers' premises that are used to send or receive information over the telephone network) were deregulated. (App. I lists common unregulated services.) Data reported to FCC by carriers for ARMIS indicate that the market for unregulated services currently generates about $3.5 billion in annual revenues.

Early in the development of enhanced services, FCC had recognized that carriers might pass on to telephone ratepayers costs properly attributable to the carriers' unregulated services. To prevent such improper cost shifting, FCC initially required carriers to offer unregulated services through separate corporate subsidiaries, which were to maintain their own financial records, staff, computer equipment, and facilities. Later, however, FCC substituted nonstructural requirements for the structural separation requirements it had imposed on carriers. In 1986, FCC applied these requirements to all major carriers, including the seven regional Bell Operating Companies (BOC) that were formed after the American Telephone and Telegraph Company (AT&T) divested itself of its local telephone operating companies in 1984.

FCC employs several accounting safeguards to look for cross-subsidization, including detailed on-site audits of carriers' records. For over a decade, FCC has used on-site

audits to meet its regulatory responsibilities—to determine whether carriers' practices and procedures (1) are in compliance with FCC standards and (2) are adequate to prevent cross-subsidization. In addition, on-site audits give FCC first-hand knowledge of carriers' cost allocation systems, serve as a check on CPA audits, and enable FCC to follow up on problems identified through other safeguards.

Since 1987, FCC has employed a number of accounting safeguards, including cost allocation standards prescribed by FCC; cost allocation manuals approved for carriers by FCC; annual independent audits performed by CPAS; FCC's reviews of these audits; and ARMIS, which FCC uses, among other things, to compare similar cost and revenue data between carriers. We did not review FCC's cost allocation standards or carriers' cost allocation manuals in this report. CPA audits are broad reviews performed for carriers in accordance with FCC guidance, often by the same firms that perform carriers' financial statement audits. Although CPAS are required to state whether carriers' cost allocation methodologies are consistent with carriers' cost allocation manuals, FCC determines, through its reviews of CPAS' workpapers and reports as well as through on-site visits, whether carriers' practices and procedures are in compliance with FCC standards. (See app. II for a more detailed discussion of FCC's regulatory actions and safeguards.)

The Accounting and Audits Division of FCC's Common Carrier Bureau is responsible for ensuring that telecommunications companies do not improperly allocate their costs. Fourteen auditors in the Audits Branch of that division are key staff responsible for oversight of carriers' cost allocations.

FCC Audit Staffing Level Is Not Adequate to Oversee Cost Allocations

In our 1987 report, we concluded that the cost allocation standards and procedures that FCC was developing and implementing were all essential. We maintained, however, that on-site audits were still necessary to protect consumers from cross-subsidization not only because cost allocation systems were inherently subjective but also because FCC had not yet tested the new safeguards.

At the time of our 1987 review, FCC's Audits Branch comprised 22 staff, including 3 supervisors, 2 secretaries, 1 statistician, 1 economist, and 15 auditors. We concluded that this staffing level was insufficient to ensure that consumers were protected against cross-subsidization, and we recommended that FCC increase its oversight through more on-site audits.

Since our previous review, FCC has not expanded its oversight of carriers' operations through on-site audits. Over the past 4 years, FCC has conducted generally about the same number of audits annually as we reported in 1987. Furthermore, the number of staff available to perform these audits has decreased. Although the number of auditors in FCC's Audits Branch remained stable through fiscal year 1988, it dropped to 12 in fiscal years 1989 and 1990 and then increased to 13 in fiscal year 1991. As of September 1992, FCC's Audits Branch consisted of 18 staff —3 supervisors, 1 secretary, and 14 auditors (see fig. 1). Meanwhile, the staff's work load has increased by 35 percent since the implementation of the accounting safeguards. Additional audit areas have been designated for on-site review, and FCC has expanded its reviews of CPAs' workpapers to ensure that the CPA audits meet FCC's regulatory needs. The Audits Branch's work load will further increase as the market for enhanced services grows and the volume of carriers' unregulated business increases.

[Figure Deleted]

FCC has acknowledged the limitations that its current audit staffing level imposes on its ability to detect cross-subsidization. In budget submissions for both fiscal years 1992 and 1993, FCC stated that this staffing level limits the assurance it can provide to the Congress and consumers that carriers are complying with cost allocation rules and that regulated services are not cross-subsidizing unregulated operations.

Since the issuance of our 1987 report, FCC has asked for additional auditors in four of its budget proposals to OMB. For fiscal years 1990 and 1991, FCC made proposals to increase the number of auditors by three for each fiscal year. However, OMB's congressional budget submissions for FCC asked for three additional auditors in 1990 and no additional auditors in 1991. Although the Congress approved 1990 and 1991 budgets, which allowed FCC to increase its staffing levels, no additional positions were allocated to the audit function. According to the former Chief of FCC's Common Carrier Bureau, he had identified other areas in the Bureau that needed more attention, and at the appropriate time, FCC would request the number of additional auditors it needed.

Subsequently, in budget requests for fiscal years 1992 and 1993, FCC asked OMB for additional auditors. FCC requested 21 additional auditors for fiscal year 1992, stating that this increase would enable the Audits Branch to review the highest-priority audit areas of each regional BOC and major independent carriers once every 5 years. The 5-year period is important because FCC cannot impose any fines or penalties more than 5 years after a cost misallocation has occurred. However, OMB reduced FCC's staffing request to three additional auditors in its fiscal year 1992 budget proposal to the Congress, and no additional staff were received as a result of that request. For fiscal

year 1993, FCC requested 10 additional auditors, stating that this increase would enable the Audits Branch to review the same significant audit areas once every 5 to 6 years. However, the fiscal year 1993 budget request that OMB submitted to the Congress contained no request for additional FCC audit staff.

To make more efficient use of existing staff, the Chief of Audits of FCC's Common Carrier Bureau has implemented a number of strategies: reducing the scope of on-site audits, reducing the size of audit teams from three to two persons where possible, targeting the most critical areas within the audit universe, and reviewing the CPA auditors' workpapers to identify potential cross-subsidies for targeting on-site audits. As an additional means of expanding its on-site audit coverage without increasing its own audit staff, FCC could consider engaging CPA firms to perform on-site audits at FCC's direction. We have not, however, evaluated the feasibility of such an approach.

Although increasing the number of FCC auditors, along with the appropriate travel funds, would increase FCC's budget, it would have little or no impact on the federal budget because FCC is authorized to charge fees to carriers for the on-site audits and reviews of CPA audits that it conducts. These fees, which are collected and deposited in the U.S. Treasury, would largely offset FCC's costs. Given the current staffing level, FCC's on-site audits of company books and records continue to be infrequent. On average, FCC annually audits about 16 of the 297 audit areas that it has designated for routine auditing to assess major carriers' compliance with FCC standards. At the present staffing level, FCC could cover each area once every 18 years. If FCC confined its efforts to the 183 areas that it has designated as most critical, it could audit each area about once every 11 years. The Chief of Audits of FCC's Common Carrier Bureau has estimated that a total of 45 auditors, along with the ap-

propriate travel funds, would be the ideal to permit on-site reviews of the most critical areas once every 5 years.

Additional Safeguards Can Be Useful, but On-Site Audits Are Still Needed

Since 1987, FCC has implemented a number of accounting safeguards to protect consumers from cross-subsidization, including (1) CPA audits of carriers' cost allocations; (2) FCC's reviews of CPAs' audit workpapers and reports; and (3) ARMIS, FCC's computerized system for maintaining carriers' cost and revenue data. Although these safeguards can give FCC useful information for monitoring carriers' operations, they have not detected all cases of cross-subsidization. Furthermore, as we noted in 1987, implementation of the safeguards does not diminish FCC's responsibility for ensuring the appropriateness of carriers' cost allocations. Finally, on-site audits have detected instances of cross-subsidization that the other safeguards have not found.

CPA Audits Frequently Have Not Been Performed in Compliance With FCC Guidance

CPA audits of cost allocation systems are required for 16 major carriers (AT&T and Tier I carriers, including the BOCs and all other local exchange carriers earning over $100 million annually in regulated revenue). In contrast to FCC's on-site audits, which review a carrier's cost allocations in a single audit area for as many as 5 years, CPA audits review a carrier's cost allocations in several related audit areas for 1 year. Whereas on-site audits emphasize detailed testing, CPA audits perform more general analyses of cost allocations in such broad

categories as affiliate transactions, time reporting, cost pools, enhanced services, and the uniform system of accounts, CPA audits are required to provide positive assurance as to whether the carriers' methodologies for separating regulated and unregulated costs are consistent with the cost allocation manuals approved for the carriers by FCC. The results of the CPA audits are reported to FCC's Common Carrier Bureau.

Although carriers hire CPA firms to perform CPA audits, FCC establishes requirements for the audits through its rules and through the guidelines that it develops in reviewing the CPAs' audit workpapers. FCC's authority to establish audit requirements is derived from regulations placed on carriers, which pass these requirements on to the CPA auditors. If a CPA audit is not performed in accordance with FCC guidelines and industry standards, FCC can prohibit a carrier from using that independent auditor for any future audit. In its rules, FCC has provided that CPAS are to follow *Generally Accepted Auditing Standards* except when these standards conflict with FCC rules.

In the order setting forth its accounting safeguards—known as the Joint Cost Order—FCC has provided that it will use CPA audits in its monitoring program but will itself make all final decisions regarding compliance. FCC will not delegate its responsibilities to the CPAS. As the order further states, the CPA audit process is an adjunct to, not a replacement for, FCC's on-site audit program.

CPA audits frequently have not been performed in compliance with FCC guidance, as FCC audit staff's reviews of 1990 workpapers for 17 audits have demonstrated. FCC staff identified at least one problem with 15 of 17 audits. Subsequently, FCC staff addressed the weaknesses in its guidance to carriers. The following examples illustrate some of the shortcomings that FCC audit staff found, the steps that they took to correct the shortcom-

ings, and—in some instances—the importance of their monitoring the CPA audits through on-site audits.

- FCC audit staff have found that CPAS' workpapers have not always adequately supported the findings from their audits. For example, FCC's review of a CPA audit disclosed that the workpapers did not provide the calculations and assumptions used to quantify its finding or show the effect of the finding on the allocation process. Thus, FCC concluded that the CPA could not support its conclusion and recommendation, nor could FCC make its own determination as to the seriousness of the finding. Our review of FCC's reports on 1990 CPA audits showed that problems with quantifying some findings of the audit work occurred in 10 of 17 audits. FCC audit staff have found that CPAS' testing has not always been adequate to ensure that carriers are complying with cost allocation rules. For example, in reviewing a CPA audit of an area for which FCC had already conducted an on-site audit, FCC found that the workpapers failed to show that the CPA had appropriately tested carrier employees' reporting of administrative time and telemarketing time. Using the information obtained from the on-site audit, FCC was able to require the carrier to make an adjustment to comply with FCC rules. Our review of FCC's reports on 1990 CPA audits showed that FCC had found detailed testing problems in 15 of 17 audits.

- FCC audit staff have found that CPA auditors have not always identified the materiality standards, or the amount of cost misallocation that the auditors consider sufficiently significant to warrant reporting. To ensure consistent and appropriate independent audits, FCC guidance requires CPAS to report these standards so that FCC can assess the suitability of the standards for the carriers. Our review of FCC's reports on 1990 CPA audits showed that FCC had found problems with

some aspect of reporting materiality standards in 11 of 17 audits.

- FCC audit staff have found that CPAs have not always adequately reviewed and tested the transactions of unregulated affiliate companies that provide substantially all of their services to a regulated affiliate company. Through information gained from on-site audits, FCC has identified components for testing and developed guidance and direction for CPA audits of affiliates' transactions. Our review of FCC's reports on 1990 CPA audits showed that FCC had identified problems with the CPAs' reviews of affiliate transactions in 13 of 17 audits.

FCC auditors are currently reviewing CPAs' workpapers for 1991 audits of carriers' cost allocation manuals. Although FCC believes the CPA audits have improved, further changes have been required to improve compliance with FCC guidelines. According to FCC audit staff, several of these changes have already been discussed in previous FCC communications. While recognizing that carriers may not have had time to comply with all of the new requirements for their 1991 CPA audits, FCC staff expect the requirements to be implemented in the 1992 audits.

In fiscal year 1993, independent CPA audits will cover 183, or about 62 percent, of the 297 audit areas that FCC has designated for all major carriers. FCC itself will perform on-site audits of only 15 audit areas covered by the CPAs. (See fig. 2.) Four of these audits will be performed only if the Audits Branch receives supplemental travel funds.

(Figure Deleted)

FCC's Reviews of CPAs' Workpapers and Audit Reports Are Not Complete

FCC oversees CPA audits and audit procedures by reviewing auditors' workpapers and audit reports, as well as by conducting on-site audits. In principle, these reviews enable FCC to ensure that the CPA audits are being, or have been, conducted in accordance with FCC specifications and therefore will be, or are, adequate to determine carriers' compliance. These reviews also enable FCC to identify weaknesses in its own guidance and to revise its requirements for CPA audits. For example, following reviews of CPA auditors' 1988 and 1989 workpapers, FCC determined that the CPA audit should be expanded to meet the standards applicable to a financial statement audit.

Because staffing limitations restrict FCC's oversight of CPA audits through on-site audits, FCC relies extensively on reviews of CPAs' workpapers to evaluate the reliability of the CPAs' work. Yet even these reviews have been limited. For the last 3 years in which review cycles have been completed, FCC auditors have been able to complete the reviews of workpapers for only 43 of the 58 CPA audits performed. Furthermore, FCC has reviewed five carriers' CPA audits only once. For fiscal year 1991, FCC had planned to review all 20 CPA audits in order to determine CPAs' compliance with new FCC guidelines. As of September 1992, FCC had completed reviews of 17 of the 20 CPA audits and performed some work on the remaining 3.

ARMIS Data Are Not Uniform

ARMIS is a computerized system containing cost, revenue, and forecast data reported by major carriers that FCC uses for a variety of its regulatory functions. FCC had anticipated that ARMIS would allow it to track trends in cost

data over time and across companies, establish benchmarks for comparison, identify disproportionate cost allocations indicative of potential cross-subsidization, and target on-site audits to carriers whose allocations appeared problematic.

For several reasons, ARMIS has not generated the comparisons that would have allowed FCC to substitute "computerized auditing" for some on-site audits. First, ARMIS does not break out cost pool data—that is, report regulated and unregulated costs for individual subaccounts—because cost pools vary from one carrier to another. Therefore, only aggregate (and less useful) comparisons are possible. In addition, each carrier's cost allocation manual contains different procedures for allocating certain costs, and carriers change these procedures throughout the year with FCC's approval. According to the Chief of Accounting Systems of FCC's Common Carrier Bureau, FCC is currently studying ways to make the cost allocation manuals uniform. He also said that if the cost allocation manuals had more uniform standards for cost pools and cost allocation procedures, then the automated reporting system could be more useful in identifying possible instances of cross-subsidy.

Despite its limitations, ARMIS did enable FCC to detect "inside wire" misallocations amounting to over $200 million. Charges for time spent by service representatives locating trouble with indoor telephone wires were inappropriately allocated to regulated services. After deregulating inside wiring and making homeowners responsible for repairs to it, FCC was expecting the regulated account balances to decrease. When ARMIS data did not reflect the anticipated decrease, FCC auditors made on-site visits to determine the extent of the misallocation. According to FCC officials, this was the only instance in which ARMIS data had enabled them to firmly identify a cost misallocation for follow-up by FCC auditors. There have

been instances in other regulatory areas where ARMIS was used to identify problems.

Through on-site audits, FCC auditors have identified cost misallocations that neither CPA audits nor FCC's reviews of CPAs' workpapers and audit reports had disclosed. For example, FCC auditors have found cases of misallocations totaling over $300 million in which carriers charged expenses to the regulated side of their businesses and carriers' affiliates had overcharged regulated carriers for services and supplies.

On-site audits have enabled FCC auditors to detect not only cost misallocations but also deficiencies in carriers' cost allocation procedures and in CPAs' audit practices and procedures. For example, in reviewing one carrier's time reporting, FCC auditors found that for a 3-year period the carrier's employees had not followed the proper procedures for allocating their time to regulated and unregulated services. The CPA was aware of the carrier's procedures, but the CPA believed it was in compliance with FCC rules. FCC auditors disagreed and required the carrier to make the appropriate changes. Because the carrier had not followed FCC's procedures and the CPA firm had not enforced FCC's procedures, about $130 million had been charged erroneously to the regulated services. Following the on-site audit, FCC auditors required the carrier to reallocate the costs that it had improperly charged to the regulated services and to revise its procedures to conform with FCC's policies and procedures.

Conclusions

In 1987, we reported that FCC had insufficient staff to ensure that consumers were protected from cross-subsidization. Since that time, FCC's responsibility for overseeing carriers' cost allocations have continued to grow, but the staff resources allocated to this function have declined rather than increased. We believe the num-

ber of FCC auditors remains inadequate to provide a positive assurance that ratepayers are protected from cross-subsidization.

Increasing the FCC staffing level, along with the appropriate travel funds, would have little or no impact on the federal budget because the government would be reimbursed for its on-site audits and reviews of CPA audits through fees FCC is authorized to collect from carriers. Given this trend of increasing work load and decreasing resources, the potential exists for ratepayers to be more vulnerable to inappropriate charges resulting from cross-subsidization in the future. Although CPA audits, FCC's reviews of these audits, and ARMIS can give FCC useful information for monitoring, they have not identified over $300 million in cross-subsidization. Further refinements to FCC audit guidance and greater uniformity in reporting cost data for ARMIS may improve FCC's information for oversight, but expanded coverage through additional on-site audits by FCC would give ratepayers and the Congress greater assurance that cross-subsidization is not occurring.

Recommendation to the Chairman, Federal Communications Commission

We recommend that the Chairman, FCC, continue to pursue the Commission's quest for additional resources to improve assurance that cross-subsidization is not taking place.

Matter for Congressional Consideration

The Congress may wish to consider authorizing additional permanent positions for auditors and the appropriate travel funds, recognizing that the funds expended would have little or no impact on the federal budget.

Agency Comments and Our Evaluation

We discussed the information contained in this report with the Deputy Chief of FCC's Common Carrier Bureau and his staff. They generally agreed with the factual information in the report, and we have incorporated their comments where appropriate . As requested, we did not obtain written agency comments on a draft of this report.

The Commission's position is that all the safeguards taken together are an effective deterrent against cross-subsidization. However, as pointed out in this report, FCC audit staff continue to find significant problems in the audits that they have been able to conduct. It is our view that the FCC audit staffing level is not adequate to oversee cost allocations, and the additional safeguards FCC employs have not been effective in detecting all cases of cross-subsidization. Consequently, we continue to believe that our recommendation that FCC continue to seek the additional resources is valid.

To update our 1987 report and determine whether FCC had increased its oversight of carriers' operations as we had recommended, we reviewed FCC's efforts to obtain additional audit staff and examined FCC's implementation of nonstructural accounting safeguards. We performed our work in accordance with generally accepted government auditing standards from September 1991 through September 1992. Appendix III contains further discussion of our objectives, scope, and methodology.

As arranged with your offices, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days after the date of this letter. At that time, we will send copies of this report to interested congressional committees and subcommittees; individual Members of Congress; the Chairman, Federal Communications Commission; the Director, Office of Management

and Budget; and other interested parties. We will make copies available to others on request.

This work was performed under the direction of Kenneth M. Mead, Director, Transportation Issues, who can be reached at (202) 275-1000 if you or your staff have any questions. Major contributors to this report are listed in appendix IV.

/s/ J. Dexter Peach
J. DEXTER PEACH
Assistant Comptroller General

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF VIRGINIA
(Alexandria Division)

C.A. Dkt. No. 92-1751-A

THE CHESAPEAKE AND POTOMAC TELEPHONE COMPANY OF VIRGINIA, ET AL., PLAINTIFFS

v.

UNITED STATES OF AMERICA, ET AL., DEFENDANTS

AFFIDAVIT OF ROBERT W. LUCKY

Robert W. Lucky deposes and says:

1. I am currently Vice President, Applied Research, at Bell Communications Research (Bellcore). I have a Ph.D in electrical engineering from Purdue University. I spent three decades at Bell Labs, where I was responsible for, among other things, research on the methods and technologies for future communications systems, including optical fiber technology, data networks, mobile communications, image processing, and broadband communications technologies and services. I have written numerous books and articles, and received numerous awards, including the Marconi Prize for contributions to data communications. In 1993, I was inducted into the New Jersey Inventors Hall of Fame at the New Jersey Institute of Technology. I have served as President of the Communications Society of the IEEE (Institute of Electrical and Electronics Engineers), and as Vice President and Executive Vice President of the parent IEEE itself.

2. Most cable systems today are operated in the broadcast mode: one centralized transmitter dispatches

information to thousands of identical receivers. By contrast, voice telephone service is two-way and interactive. Any subscriber can communicate personally with any other subscriber.

3. Until very recently, video television signals were delivered to households over a form of metal wire called "coaxial cable." Coaxial cable was the best medium available for distributing one-way video signals to consumers. The broadcast networks deployed by cable companies were not suitable for providing two-way voice telephone service. Telephone service was provided, instead, over "twisted pair" copper wires. Cable and telephone wires were physically different. Coaxial cable consisted of a metal wire running down the middle of cylindrical metal sheath. "Twisted pair" telephone wiring consisted of two identical copper wires twisted together in a double helix.

4. Both telephone companies and cable companies are now replacing metal wires with fiber-optic glass cable. Signals are translated into digital form (as a series of on-off pulses) and transmitted as flashing laser light through thin strands of very pure glass. Fiber optic communication systems handle video, voice, and data in exactly the same way. The information is all digital. It is transmitted over the same facilities, in the same way, whether it represents a rerun of "I Love Lucy," a phone call on Mother's Day, or a stock quote from Wall Street.

5. For example, East Buchanan Telephone in Winthrop, Iowa, has about 600 cable and 1,300 telephone subscribers, served over a single backbone network that was upgraded to fiber in Spring 1992.[1] The FCC has likewise permitted GTE to build and maintain an integrated, high-capacity test network in Cerritos, California,[2] which

---

[1] L. Ellis, *What's Happening Under the Cross-ownership Fence,* Communications Engineering and Design, Mar. 1993, at 64.

[2] General Telephone Co. of California, 64 Rad. Reg.2d (P & F) 1156 (Common Carrier Bur. 1988), *aff'd,* 4 F.C.C. Rcd 5693 (1989),

will eventually provide voice, video, and data signals by way of fiber, coaxial, and copper wire, to 5,000 homes. In the Cascades development community in Loudoun County, Virginia, the C&P Telephone Company of Virginia is providing transport for video programming of third parties using fiber optic technology. Bell Atlantic has also announced an agreement to provide fiber-optic video transport to almost 12,000 households in Florham Park, Madison and Chatham, New Jersey.[3] In Dover, New Jersey Bell has announced a similar plan to provide fibre-optic video transport to approximately 38,000 residences, in competition with the incumbent CATV operator.[4]

6. Even as they deploy glass fiber, both cable companies and telephone companies are deploying new technologies to upgrade the capabilities of their existing metal-wire networks.

7. Recently developed new technologies permit telephone companies to transport full-motion color video programs directly to subscribers over the existing telephone network. A new technology known as ADSL

---

remanded sub nom. National Cable Television Ass'n, Inc. v. FCC, 914 F.2d 285 (D.C. Cir. 1990).

[3] Application, *In re* Application of NEW JERSEY BELL TELEPHONE COMPANY For authority pursuant to Section 214 of the Communications Act of 1934, as amended, to construct, operate, own, and maintain, advanced fiber optic facilities and equipment to provide video dial tone service within a geographically defined area in the municipalities of Florham Park Borough, Madison Borough, and Chatham Borough, New Jersey, File No. W-P-C 6838 (F.C.C. Nov. 16, 1992).

[4] Application, *In re* Application of NEW JERSEY BELL TELEPHONE COMPANY For authority pursuant to Section 214 of the Communications Act of 1934, as amended, to construct, operate, own, and maintain, advanced fiber optic facilities and equipment to provide video dial tone service within a geographically defined area in Dover Township, Ocean County, New Jersey, File No. W-P-C 6840 (F.C.C. Dec. 15, 1992).

(Asymmetric Digital Subscriber Line) makes possible the simultaneous transmission of both voice and video signals over existing copper telephone wires. This marks a major, and potentially very important advance in technology—one that was wholly unforeseen a decade ago. ADSL is already being deployed in service trials. Bell Atlantic has recently been granted permission by the FCC to test ADSL technology in 400 homes in Northern Virginia.[5]

8. For their part, cable companies are grafting two-way voice capabilities on to their networks. A new generation of radio phones, much like existing cellular phones but smaller and cheaper, is now being licensed by the FCC. Cable interests have become leading developers of these "personal communications services." According to estimates cited in August 1992 by the FCC, these radio-based systems may well provide telephone service to 60 million American subscribers by the end of the 1990s.[6] For example, a major cable company (Time Warner) recently made a presentation to financial analysts in which it described its plans to deploy a full-service, voice, video, and data network.[7]

9. In sum, the technology of both cable and telephony has evolved dramatically in the last decade. A decade

---

[5] Application, *In re* Application of THE CHESAPEAKE AND POTOMAC TELEPHONE COMPANY OF VIRGINIA For authority pursuant to Section 214 of the Communications Act of 1934, as amended, to construct, operate, own, and maintain, facilities and equipment to test a new technology for use in providing video dial tone within a geographically defined trial area in Northern Virginia, File No. W-P-C 6834 (F.C.C. Oct. 21, 1992).

[6] *In re* Commission's Rules to Establish New Personal Communications Services, 7 F.C.C. Rcd 5676, 5697 (1992) (citing *Market Researchers See Large Demand for PCS in U.S.*, Microcell News, Mar. 25, 1992.).

[7] *Time Warner to Build Data Network in Fla.*, Reuters, Jan. 26, 1993, Financial Report.

ago, cable and telephone used different kinds of metal wires. Today, both are deploying glass. A decade ago, different types of metal-wire network supported different types of transmission. Today, new technology permits video over existing telephone wires, and voice over a combination of radio and cable.

I declare under penalty of perjury under the laws of the United States of America that the foregoing is true and correct. Executed the 26th day of April, 1993.

/s/ Robert W. Lucky
ROBERT W. LUCKY
Vice President, Applied Research
Bell Communications Research
331 Newman Springs Road
Room 3Z367A
Red Bank, New Jersey 07701-7040

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF VIRGINIA
(Alexandria Division)

[Caption Omitted in Printing]

AFFIDAVIT OF WILLIAM E. LEE

1. My name is William E. Lee. I am a Professor in the Henry W. Grady College of Journalism and Mass Communication at the University of Georgia. I earned a Doctorate degree in Mass Communications at the University of Wisconsin in 1977 and have been on the faculty at the University of Georgia since 1977. I have taught courses on the structure and practices of the mass media and have published extensively on mass communication. I have testified as an expert on mass communication at seven trials and have provided expert testimony through affidavits or depositions in seven other lawsuits. The matters set forth and the opinions expressed herein are known or personally held by me and if called as a witness, I could testify competently to them.

2. Based on my background in the field of mass communication, I make three principal points in this affidavit. First, the creation, selection, arrangement, packaging and provision of video programming for multichannel delivery, whether it is performed by a cable company or by Bell Atlantic Video Services ("BVS"), involves editorial decisions that are functionally indistinguishable from those involved in newspaper editing. Second, today video communication is the most important mass medium in America. Third, the ban against telephone company provision of "video programming" at issue in this lawsuit cannot be understood or enforced without reference to, and gov-

ernment scrutiny of, the content of individual programs or services.

I. *Editorial Decision-Making By Multichannel Video Programmers and Newspapers*

3. Based on my review of the pleadings in this case and on discussions with employees of BVS, I have gained an understanding of the nature of the services that BVS intends to provide. Specifically, BVS intends to provide a multichannel package of video programming directly to consumers. Although BVS will use the common carrier telephone network of The Chesapeake and Potomac Telephone Company of Virginia ("C&P") to deliver this programming, BVS itself will not act in any sense as a common carrier. Rather, BVS will exercise complete editorial discretion over the package of programming it will provide, whether BVS decides to create programming of its own, or selects, assembles, edits and arranges video programming obtained from others. In this respect, BVS will perform the same editorial functions performed by cable operators in selecting and packaging the programming provided over their cable systems. As I will explain below, moreover, the editorial functions performed by BVS and other multichannel programmers are indistinguishable from those performed by newspapers.

Multichannel Video Programmers

4. At the outset, it is important to point out that multichannel video programmers exercise editorial discretion in two separate respects. First, these programmers exercise editorial discretion in choosing the programming they will provide. Second, once this initial selection is made, multichannel programmers exercise editorial discretion in arranging and packaging this programming for sale to consumers. I address each of these functions below.

5. Multichannel video programmers must choose among available programming options because of both technical and financial constraints. Currently most multichannel video programming is delivered over cable systems that have limited channel capacity, and the supply of available programming exceeds the capacity of virtually all cable systems. Even apart from these capacity limitations, however, multichannel video programmers also face financial constraints on the number and types of video programs for which consumers will pay. As a result, multichannel programmers must exercise discretion to choose among the available programming options.

6. Multichannel video programmers make programming decisions based upon two distinct strategies. Some programming services, such as broadcast stations, are selected because of their appeal to broad segments of the audience. Other programming services, like Black Entertainment Television, are selected because they appeal to narrow racial, ethnic, age, or interest groups. Some programming services are identified with particular subjects and viewpoints. For example, the Family Channel offers a different view on sexual morality than does the Playboy at Night service. The interest of audience segments in certain topics and viewpoints influences the selection of programming. The primary programming options for multichannel video programmers are briefly described below:

a. Multichannel video programmers select which broadcast stations to carry. The selection of broadcast stations is affected by the number and nature of stations in the local and adjacent markets, and by whether (and how much) a multichannel provider must pay for "retransmission" rights for a broadcaster's signal. Since the most-watched sources on cable are the major network (ABC, CBS and NBC) broadcast affiliates, multichannel video programmers naturally retransmit the signals of local affiliates. However, a multichannel video program-

mer may wish to carry two affiliates of the same network located in adjacent markets. Although the network programming on both stations will be duplicative, the additional station is selected because of factors such as audience interest in news from the adjacent market. Multichannel video programmers must also determine which local independent stations to retransmit. For example, a suburban cable system may prefer not to carry an independent television station that broadcasts in a foreign language that is of interest only to urban residents. Every broadcast signal that is carried reduces the options the programmer has for other types of programming.

b. Multichannel video programmers also select among cable programming services such as the 75 plus basic cable network, 42 regional networks, 7 pay cable networks, 7 pay-per-view networks, 10 text services, and 11 audio services. (Attachment A lists the available cable programming services.) While some of these services seek to reach broad audiences, others are "niche" services that appeal to a very limited age or interest group. In 1991-92, 43% of viewing time in cable households was devoted to basic and pay cable services. *See* Stipulation 8. The audience for each service, therefore, represents a very small portion (often less than 1%) of the total audience; selection of the appropriate mix of services entails the identification of small groups whose interests are not served by other sources.

c. Currently, approximately forty-one percent of cable systems in the United States carry locally originated programming. *TV & Cable Factbook, Services Volume* at I-68 (1993 edition). The types of local programs include sports, comedy, children's, talk, music, and news. Because a cable system serves a more limited geographic area than the multi-country region served by a television station, a cable system is able to provide programming more closely tailored to the interests of a particular town. For example, one of the most significant recent developments in local cable programming is the coverage of local

news. A broadcast television station's news necessarily focuses on the major city in the television market, such as Washington, D.C., or on stories of regional interest, but provides little coverage of the many smaller communities located within the station's market. A cable system, however, can fill in the news "niches" left untouched by broadcast television news. Thus, local cable news is merging in places like Long Island, New York and Orange County, California that are largely ignored by broadcast television news. These cable news operations range in size from the twenty-four-hour service in Long Island, to daily half-hour newscasts in communities such as Ithaca, New York, to brief inserts of local news in CNN Headline News. The cost of producing local news coverage, however, is a major obstacle to the development of these services. *See, e.g.*, "Local News Stymies Many Cable Firms," *Wall Street Journal*, June 15, 1991, at B1. To control costs, multichannel video programmers are entering cooperative arrangements with local broadcasters and newspaper publishers. For example, some broadcasters prepare coverage of elections just for dissemination on cable. *See, e.g.*, "KYW-TV Election Coverage: Via Cable Systems," *"Broadcasting*, November 4, 1991, at 48 (describing Philadelphia, Pennsylvania television station's arrangement with local cable systems). Some multichannel video programmers allow either local broadcasters or newspapers to insert a brief summary of local news in a cable program service such as Headline News or a weather update in the Weather Channel. *See, e.g.*, "System Teams Up with Local Paper, Broadcaster," *Multichannel News*, August 20, 1990, at 14 (describing Rock Hill, South Carolina cable system's arrangement).

7. In addition, once the multichannel video programmer selects the programming it will provide, it must package the programming for sale to consumers. In doing so, the programmer exercises editorial discretion both in terms of determining where particular programming is positioned in the channel lineup, and in terms of determining

which programming to include in particular packages. For example, the programmer must decide which programming to include in a "basic" package, in more inclusive packages, and as "premium" services.

8. In summary, whether deciding to carry material produced by others, whether and how to cover local events, or how to arrange and package programming for sale, multichannel video programmers make choices about the programming content offered to subscribers. Such choices are affected by audience demographics, audience interests, ideology, and technological and financial constraints. The process of editorial choice engaged in by multichannel video programmers is no different than that engaged in by newspapers.

Newspapers

9. As in the case with multichannel video programmers, newspaper publishers also face constraints on the amount and type of news content included in their papers. The most important source of newspaper revenue is from the sale of advertising space; 78% of a newspaper's revenue comes from advertising, with the remaining 22% from subscriptions. *The Veronis, Suhler & Associates Communications Industry Forecast* at 39 (1992). Consequently, the amount of news and feature content is usually determined by the number of advertisements that have been sold. The typical newshole—the space allocated to news and features—is about 40% of a newspaper's content. J. Dominick, *The Dynamics of Mass Communication* at 203 (2nd ed. 1987). On a heavy advertising day, the newshole may be only 25% of the paper's contents. D. Pember, *Mass Media in America* at 59 (4th ed. 1983). Newspaper editors, thus, must carefully select the newshole content from among the available options.

10. Like multichannel video programmers, contemporary newspapers provide information of interest to a

general audience as well as information of interest to segments of the audience, such as cooking, science, and finance. Through readership studies, editors seek to identify both the general and special interests of the audience; news content is a product designed to be purchased by readers. Newspaper editorial costs typically range from 14 and 22% of total costs. J. Udell, *The Economics of the American Newspaper* at 122 (1978). Because editors must stay within a budget, the relative cost of various types of content is a factor in selecting material. For example, the use of syndicated or news service material may cost less than material written by the newspaper's staff.

11. The primary newshole options available to a newspaper are briefly described below:

a. With the exceptions of very large circulation newspapers, typical newspapers rely upon news services such as the Associated Press for national and international news. Information from these services can be rewritten by the newspaper's staff, or carried without alteration. A 1986 study found that Associated Press member papers fill 37% of their newsholes with AP copy. C. Fink, *Strategic Newspaper Management* at 167 (1988). There are approximately 142 news and picture services available to newspapers. *Editor & Publisher International Yearbook* at V-1-6 (1992).

b. Newspapers also rely upon feature syndicates for material such as cartoons, editorial cartoons, sports box scores, weather maps, and columnists. This material is provided to the newspaper in a form that is ready to print, and is generally carried without editing by the newspaper. Syndicated material may fill up to 18% of the newshole. Since hundreds of newspapers buy from a syndiate, the cost to a newspaper for these features is relatively low; the cost of hiring a columnist to write solely for one newspaper is greater than the cost of buying a syndicated column. There are approximately 417

entities offering syndicated material to newspapers. *Editor & Publisher International Yearbook* at V-7-12 (1992).

c. Many Sunday newspapers include preprinted inserts such as comics sections, magazines like *Parade*, and television listings such as *TV Log*. Newspapers make no alteration of the content of these sections; the material is prepared and printed elsewhere and merely included within the newspaper. The choice the newspaper makes is whether to have such a section, and if so, which of the available services should be selected. A newspaper serving a community that is heavily Hispanic may chose *Vista—The Hispanic Magazine* over *Parade*, but does not alter or edit the selected magazine. There are 12 comics sections, and 10 magazines available to newspapers. *Editor & Publisher International Yearbook* at V-12-17 (1992).

d. Editors may assign reporters to cover local events. News policies, such as avoiding negative references about major advertisers, influence coverage. *See* L. Solely & R. Craig, "Advertising Pressures on Newspapers," 21 *J. of Advertising* 1 (1992). The perception of what is news, based on analysis of factors such as timeliness, proximity, prominence, consequence, and human interest, also determines what events the newspaper assigns reporters to cover. Cost also influences local coverage; some stories, such as those involving lengthy investigations, cost more to prepare than others.

12. In summary, like multinational video programmers, newspapers frequently carry material prepared by others. The newspapers nonetheless exercise editorial discretion by determining in the first instance whether the material should be published, and also in determining the editorial arrangement of the content. Whether selecting and arranging material provided by others, or deciding how to cover local news, newspaper content is affected by audience demographics, audience interests, ideology, and technological and financial constraints, just as the content

of a multichannel video programmer's package of programming is affected by these same factors.

BVS's Services

13. Based on the understanding I have gained of the nature of the services BVS intends to offer, it is also clear that BVS's editorial process is comparable to that of newspapers and of other multichannel video programmers. It merits noting that my opinion expressed in this affidavit is not affected by the content of particular programs BVS intends to offer. Instead my opinion is based on the kinds of activities in which BVS is currently engaged.

14. In preparing its programming plan, BVS conducted research concerning audience demographics, and completed its own proprietary marketing survey of Alexandria residents. In addition, the company acquired reports of meetings of the Alexandria Cable Television Advisory Commission, as well as the results of a survey of cable subscribers conducted by Jones Intercable, the incumbent cable operator.

15. Through this research BVS learned that consumers are interested in specific services not offered by Jones Intercable. For example, in 1992 Jones deleted all of the Baltimore television stations it carried to make room for four cable program services. BVS intends to offer those Baltimore stations to its subscribers. BVS also learned of subscriber interest in WGN, a Chicago superstation, and as a result intends to offer it to subscribers. In response to consumer interest in greater variety, BVS will offer more local and adjacent-market broadcast signals, basic cable networks, and premium cable networks, than does Jones. Finally, BVS found that there was significant audience interest in video-on-demand, a service that permits consumers to order any one of potentially hundreds of programs from a library of stored videos for viewing at any time. This is also a service that is not offered by Jones.

16. Although BVS seeks to offer diverse programming, the company has established editorial standards governing the portrayal of sex and violence. The community accepts the level of sex and violence offered on services such as HBO. More explicit material, however, will not be offered. Based on these standards, the company has decided not to carry Spice or Playboy at Night, two sexually explicit programming services. The standards governing sex and violence will also be used in the selection of material to be included in the video library. Standards governing other types of content will be developed in conjunction with the community as the company gains experience with video programming. BVS intends to sell advertising time and will have standards on advertising content similar to those of local broadcasters.

17. In creating the video library for its video-on-demand service, BVS intends to arrange the programming it chooses for inclusion into six categories: entertainment, living, learning, buying, communication, and information seeking. Each segment is further divided into a number of subdivisions. For example, within the entertainment segment are subdivisions for movies, sports, and video games. The video library provides consumers with a significant increase in programming options. However, "shelf space" within the library is not infinite. Thus, BVS must carefully select the programming included in the video library to reflect audience interests, community standards, and creative judgments.

18. BVS's editorial discretion concerning the development of the video library operates at several levels. First, the company selected the segments to be included. Second, it selected the specific programming services, or individual programs, to be made available to consumers. Third, BVS is arranging categories, subdivisions, and navigational aids to guide the consumer in a manner similar to that in which a newspaper lays out its sections and

pages. Fourth, to aid the user, BVS is prioritizing menu listings. For example, within a subcategory such as action-adventure films, BVS will offer a listing of "top" films, as well as a more inclusive listing. Fifth, BSV is packaging programs according to themes, and is combining programs for "best of" presentations. Thus, while some viewers may be interested in all of the episodes of "Cheers," others may prefer BVS's compilation of what it regards as the best episodes. Sixth, reflecting its concern for parental control over children's use of the library, BVS is organizing material according to age categories and is offering parents the ability to "lock-out" certain segments, subdivisions, and program sources. Seventh, because there is community interest in specific types of local programs, BVS will make equipment and studios for the production of local programming available; this programming will be archived in the video library.

19. In summary, BVS's editorial decision-making is the same as that of other multichannel video programmers or newspapers. The company's decisions concerning which programming services to offer are based on market studies that reveal consumer interests unmet by the incumbent cable operator. Moreover, the company has adopted standards, based on community attitudes, concerning depictions of sex and violence. BVS is also exercising editorial discretion in the selection and packaging of the video library.

II. *The Significance of Video Programming As A Medium of Mass Communication*

20. The importance of video programming as a medium of mass communication today is beyond dispute. Video programming is now the dominant means by which people obtain news, information and entertainment. Whether one thinks in terms of television coverage of important events such as the Watergate hearings, the Gulf

War or political campaigns, or in terms of video entertainment including movies such as "Dances With Wolves" that combine gripping visual imagery with important social messages, video programming communicates messages and ideas in a manner that cannot be fully duplicated through use of print or audio media alone. Moreover, while these are not matters that are subject to any dispute, the importance of video programming can be illustrated by reference to empirical data.

21. For example, the importance of video programming as a medium of communication is illustrated by comparing the amount of time people spend with various media, the amount of money people spend on various media, and the amount of money advertisers spend on various media. Specifically, Tables I-IV in Attachment B reveal that in 1991 consumers spent more time with broadcast and cable television than any other medium, and spent more money on cable subscriptions than on the purchase of any other media product. While newspapers remain the largest single advertising vehicle, in 1991 the total advertising and consumer expenditures on broadcast and cable television, $41.8 billion, exceeded the total advertising and consumer expenditures on daily newspapers, $39.6 billion, by $2.2 billion. The amount spent on video tape rentals and purchases in 1991 exceeded box office revenues by $6.1 billion.

22. It is also important to note a number of trends concerning media usage. First, the percentage of adults reading newspapers daily has been declining, and was at 62% in 1991. *The Veronis, Suhler & Associates Communications Industry Forecast* at 171 (1992). Second, cable penetration as a percentage of television households has increased markedly to over 60% today. Accompanying the increase in cable penetration has been a shift in viewing patterns. Broadcast stations' share of total television viewing has declined from 87% in 1986 to 73.5% in 1991. In the same period basic and pay cable services'

share of total television viewing has increased from 13% to 26.5%. *Id.* at 77. In households that subscribe to cable, moreover, 43% of viewing time was devoted to cable-originated programming as of 1991-92. Third, the percentage of television households with a VCR has increased from 37.8% in 1986 to 73.7% in 1991. *Id.* at 127. Expenditures on the rental and purchase of prerecorded video tapes have increased from $5 billion in 1986 to $10.9 billion in 1991. *Id.*

23. Television has become the dominant news source for most Americans. Television is a main news source for 66% of Americans, compared to 36% for newspapers and 14% for radio. The Roper Organization, *America's Watching: Public Attitudes Toward Television* at 18 (1987) (respondents were allowed to mention more than one medium as a main news source, thus the percentages add up to more than 100). The increasing reliance on television news is explained in part by its credibility. Since 1961 television has been perceived as the most credible news medium, and its lead continues to increase. *Id.* at 5. A February 1993 poll revealed that the Cable News Network (CNN) was the most believable news source, followed closely by ABC, CBS, and NBC. Times Mirror Center for the People and the Press, *Times Mirror News Interest Index* at 1 (March 3, 1993). Daily newspapers were considered to be less believable than CNN and the major broadcast networks. *Id.* Significantly, although NBC News was damaged by the revelation that it staged the explosion of a General Motors truck, it was still regarded as more believable than daily newspapers. *Id.*

24. Television is especially important as a means of political communication. It has become the dominant source of both national and local political news. The Roper Organization, *America's Watching: Public Attitudes Toward Television* at 6-7 (1987). It has altered how

campaign resources are expended, how campaign organizations are structured, and how compaigns are conducted. Because of the heavy expenditures on television advertising by politicians, the costs of campaigning have increased. In fact, the largest category of expenditure for House, Senate, and Presidential campaigns is for television advertising. *See, e.g.*, S. Fritz & D. Morris, *Handbook of Campaign Spending: Money in the 1990 Congressional Races* at 53-57 (Cong. Q. 1992). *See generally* E. Diamond & S. Bates, *The Spot: The Rise of Political Advertising on Television* (1988 ed.). Nominating conventions and campaign activities are organized for television coverage. Campaign staffs typically include consultants who advise the candidate on his or her television image. *See* M. McCubbins, ed., *Under the Watchful Eye: Managing Presidential Campaigns in the Television Era* (1992). Although the impact of these developments on voting behavior is not clear, the behavior of candidates reveals that they regard television as the critical means of cultivating voter awareness.

25. While providing news and entertainment, television functions as a socialization agent by transmitting values, presenting role models, and communicating acceptable behaviors. The relative importance of television as a socializing agent is underscored by the medium's pervasiveness and accessibility, and by the amount of time people spend viewing. Ninety-eight percent of all American homes have television and the average home has 2.1 sets. U.S. Dept. of Commerce, Bureau of Census, *Statistical Abstract of the United States 1992* Table 884 (112th ed. 1992). Television is accessible to all income and educational groups. In contrast, newspaper consumption requires literacy, and increases as education and income levels increase. *Id.* at Table 885. Television's accessibility is also enhanced by its low hourly costs to users; even when cable subscriptions are included, total television viewing cost only 6 cents per person per hour in 1991. By comparison, newspapers cost

29 cents per hour, magazines cost 38 cents per hour, and books cost 69 cents per hour. *The Veronis, Suhler & Associates Communications Industry Forecast* at 14 (1992). And as Table I illustrates, people spend more time with television than any other medium. No medium in our society transmits as many social cues, to as many people, as frequently, as does television.

26. The combination of sight and sound in video programming provided by television make it a distinctive communications medium. Television can depict the real world, but it also can create images and sounds that are "unreal." Television's visual images change rapidly, through techniques such as cutting between cameras, zooms and pans; through the use of special effects; and through the image manipulation made possible by advances in computer technology. Television dialogue may be life-like, but the audio portion of television may also include enriching features like musical accompaniment and sound effects. These audio and visual techniques sustain interest in the program, but also convey meaning. For example, children quickly learn that a fade or dissolve signals a change in time or location. Researchers have posited that this combination of visual and auditory components make television distinct from other media. *See, e.g.*, A. Huston & J. Wright, "Children's Processing of Television: The Informative Functions of Formal Features," in J. Bryant & D. Anderson, eds., *Children's Understanding of Television* (1983). The communicative features of the video programming that is provided over television are unmatched by print, photographs, or radio.

27. A multichannel video service, such as that proposed by BVS, provides a unique communication environment. The programmer may employ distinctive programming strategies, such as seeking to reach both broad and narrow audience segments. As a result, audience members may employ a range of information-seeking strategies, driven by general or highly specialized interests. In addition, the

proposed video-on-demand feature enables the consumer to access an extraordinary range of video information without the time constraints posed by broadcast station or cable channel scheduling. Most importantly, video-on-demand permits viewers to more efficiently seek information relevant to them. Video-on-demand transforms the customary television-viewing question from "What's on tv?" to "What can *I* put on tv?"

III. *Enforcing the Video Ban Requires Government Scrutiny of Program Content*

28. When Congress created the ban on "video programming" in 1984, it defined the subject of its prohibition to include video programming "provided by, or generally considered comparable to" video programming provided by broadcast stations. This prohibition can only be understood or enforced by reference to, and government scrutiny of, the content of individual programs or services that telephone companies provide.

29. The very language chosen by Congress emphasizes the need for government officials interpreting and enforcing the ban to exercise their subjective judgment to determine if a particular program is forbidden "video programming." The ban does not apply to all "video images." Nor does its apply to particular technologies, such as over-the-air broadcast technologies. Rather, the ban focuses on the content of the service being provided. If, in the judgment of the appropriate government officials, the program would be "generally considered comparable to" programming provided by broadcasters, then it is forbidden. If in their subjective judgment the program would not be considered comparable, then it is permitted.

30. In today's environment of rapidly changing technologies, government officials will frequently be called upon to exercise their judgment as to what is and what is not "video programming." Unlike 1984, when voice,

data and video were largely discrete services delivered using separate technologies, these services are no longer discrete, nor are they delivered using different technologies. For example, services available today can mix voice, data, text and video together in a variety of combinations. These services range from relatively simple videotext services such as airline guides that can be displayed either on television or personal computer screens, to complicated multi-media services that are fully interactive. But whether these services, or other new services that are being or will be developed, qualify as "video programming" turns upon a subjective view of whether the content of the service is "comparable to" programming provided by broadcasters.

31. Moreover, the concern that the statute will set government officials up to act as censors of what is and is not permitted is not a speculative one. The scope of the ban has been the subject of considerable dispute, and has been extensively litigated before the FCC. Without regard to whether the FCC's chosen interpretation of the scope of the ban is correct or incorrect, the efforts of the FCC to grapple with the problem serve to illustrate the basic point that the ban can only be understood through reference to the content of particular programs.

32. Specifically, in its 1992 "Video Dialtone" order, the FCC was called upon to address whether some of the new services containing video images qualify as "video programming." As an initial matter, however, the Commission had to determine the appropriate reference point for comparing these services to programming provided by broadcasters. Based on the legislative history, the Commission interpreted the statutory language to mean that "Congress intended to prohibit only telephone company provision of programming comparable to that provided by broadcast stations in *1984*." *Telephone Company-Cable Television Cross-Ownership Rules*, 7 FCC Rcd 5781, 5820 (1992). *See also* 130 Cong. Rec. H12235 (daily ed. Oct. 11, 1984) (the House notes that the term "video

programming" refers to programming generally provided by a television broadcast station *today*).

33. In deference to the subjective nature of the statutory ban, the FCC adopted what it described as a "severability" standard. This standard considers whether a particular service is interactive, but does not consider this factor to be determinative. According to the FCC, "to the extent a service contains severable video images capable of being provided as independent video programs comparable to those provided by broadcast stations in 1984, that portion of the programming service will be deemed to constitute 'video programming' . . . ." 7 FCC Rcd at 5821. As a result, telephone companies are permitted to provide the underlying technical capabilities that make an interactive service work, but may still be barred from providing the actual programming content for the service if, in the FCC's subjective opinion, it is comparable to programming provided by broadcasters.

34. The Commission elaborated on its "severability" test by offering some examples:

> —According to the FCC, a shopping service or "video catalogue" that allows consumers to "electronically request specific goods and services would not constitute prohibited video programming, even if the service incorporated video images. In such a case, the video images would not be severable from the interactivity." *Id.* at 5822. But home shopping programs, even those enabling the consumer to order a product electronically, would be prohibited if they resemble home shopping programs broadcast in 1984. *Id.*
>
> —Likewise, an educational multimedia presentation containing video images is generally permissible as long as it includes enough textual or graphic information and interactivity that the content demonstrably differs from what broadcasters provided in

1984, but "the simple inclusion of some textual information" would not transform a "severable video program into a permissible multimedia program." *Id.* at 5822 n.196.

—Providing the video programming content for interactive pay-per-view and video-on-demand services is prohibited because the programming is severable from the function of ordering programming; but strictly one-way services such as videotext news services, stock market information, on-line airline guides, and downloading of video games and computer software are permissible because the content of these services is sufficiently different from programming provided by broadcasters. *Id.* at 5822-23 & n.199.

35. None of these distinctions between permissible and impermissible programming can be maintained by reference to technical considerations. For example, there is not technological basis for distinguishing one form of multimedia tele-shopping from another. Video and audio information can be delivered over telephone lines, cable, and other media, displayed on a personal computer or a television receiver. All formats offer instant ordering capability. Consequently, a ban on home-video shopping of the kind provided by television in 1984 can be enforced only by a highly subjective comparison of the content of contemporary programs with programs from 1984. The same subjective comparison occurs with other types of services, and the need for these subjective comparisons will increase. In 1984, a video news program with occasional text captions was recognizably different from a videotext service like NEXIS that was provided over a telephone line. But with today's merging media formats, it is possible to deliver text, pictures, sound, and interactive search-and-selection capabilities through a variety of delivery systems. In short, the only way the FCC can distinguish between impermissible "video programming" and permissible programming is to examine the content

frame by frame, sound bite by sound bite, caption by caption, with the kind of programming offered on television in 1984.

/s/ Wm. E. Lee
WILLIAM E. LEE

[Notarization Omitted in Printing]

ATTACHMENT A

CABLE PROGRAMMING SERVICES

AUDIO ONLY

AEI MUSIC NETWORK
BIBLE BROADCASTING NETWORK
CABLE RADIO NETWORK
DIGITAL CABLE RADIO
DIGITAL MUSIC EXPRESS
GALACTIC RADIO
KLON LOS ANGELES-THE JAZZ NETWORK
MOODY BROADCASTING NETWORK
MUTUAL BROADCASTING SYSTEM INC.
SATELLITE RADIO NETWORK
WFMT CHICAGO

CANADIAN

CATHAY INTERNATIONAL TELEVISION
FIRST CHOICE—THE MOVIE NETWORK
MUCHMUSIC NETWORK
LE RESEAU DES SPORTS
THE SPORTS NETWORK
STORYVISION NETWORK
SUPERCHANNEL

PAY SERVICES

CINEMAX
THE DISNEY CHANNEL
ENCORE
HOME BOX OFFICE INC. (HBO)
THE MOVIE CHANNNEL
PLAYBOY AT NIGHT
SHOWTIME NETWORKS INC.

PAY-PER-VIEW

ACTION PAY-PER-VIEW
CABLE VIDEO STORE
GUEST CINEMA
REQUEST TELEVISION
SPICE
VIEWER'S CHOICE
VIEWER'S CHOICE II

REGIONAL PROGRAMMING

ARIZONA SPORTS PROGRAMMING
ATLANTA INTERFAITH
CABLE TV NETWORK OF NEW JERSEY INC.
ECUMENICAL TV CHANNEL
EMPIRE SPORTS NETWORK
HOME SPORTS ENTERTAINMENT
HOME TEAM SPORTS
IOWA CABLE NETWORK
JEWISH TELEVISION NETWORK
KBL SPORTS NETWORK
MADISON SQUARE GARDEN NETWORK
MEADOWS RACING NETWORK
MIDWEST SPORTS CHANNEL
NEW ENGLAND CABLE NEWS
NEW ENGLAND SPORTS NETWORK
NEW YORK 1 NEWS
NEWS 12 LONG ISLAND
NEWSCHANNEL 8
NIPPON GOLDEN NETWORK
ORANGE COUNTY NEWSCHANNEL
PENNARAMA
PENN NATIONAL RACING ALIVE
PHILADELPHIA PARK LIVE
PRIME SPORTS NETWORK
PRIME TICKET NETWORK
PRISM
PRO AM SPORTS SYSTEM
RTP—USA
RURAL ALASKA TELEVISION NETWORK
SAN DIEGO CABLE SPORTS NETWORK
SATELLITE SPORTS NETWORK
SPORTSCHANNEL CHICAGO
SPORTSCHANNEL FLORIDA
SPORTSCHANNEL LOS ANGELES
SPORTSCHANNEL NEW ENGLAND
SPORTSCHANNEL NEW YORK
SPORTSCHANNEL OHIO
SPORTSCHANNEL PACIFIC
SPORTSCHANNEL PENNSYLVANIA
SPORTSCHANNEL NETWORK
SUNSHINE NETWORK
TSC-THE SPORTS CHANNEL

SATELLITE PROGRAMMERS

ACTS SATELLITE NETWORK
ALL NEWS CHANNEL

ALTERNATIVE VIEW NETWORK
AMERICA'S DISABILITY CHANNEL/THE
SILENT NETWORK
AMERICAN MOVIE CLASSICS
THE ARABIC CHANNEL
ARTS & ENTERTAINMENT TELEVISION
BIZNET
BLACK ENTERTAINMENT TELEVISION
THE BOX
BRAVO
CABLE NEWS NETWORK
CABLE SATELLITE PUBLIC AFFAIRS NETWORK
C-SPAN 2
CANCOM
CNBC
COKESBURY SATELLITE NETWORK
COMEDY CENTRAL
COUNTRY MUSIC TELEVISION
COURT TV
DEEP DISH TV NETWORK
DISCOVERY CHANNEL
E! ENTERTAINMENT TV
ESPN INC.
ETERNAL WORD TV NETWORK
THE FAMILY CHANNEL
FAMILYNET
GALAVISION
GOLDEN AMERICAN NETWORK
THE GREEK CHANNEL
HEADLINE NEWS
HIT VIDEO USA
HOME SHOPPING NETWORK
HOME SHOPPING NETWORK 2
HSNE
INTERNATIONAL CHANNEL
INTERNATIONAL TELEVISION BROADCASTING
KEYSTONE INSPIRATIONAL NETWORK
THE KOREAN CHANNEL
KTLA LOS ANGELES
KTVT DALLAS
THE LEARNING CHANNEL
LIFETIME
MIND EXTENSION U
MTV: MUSIC TELEVISION
NASA SELECT
THE NASHVILLE NETWORK
NATIONAL JEWISH TV
NETLINK USA

THE NEW INSPIRATIONAL NETWORK
NICK AT NITE
NICKELODEON
NOSTALGIA TELEVISION
PREVUE GUIDE
PRIMETIME 24
PUBLIC INTEREST VIDEO NETWORK
QVC FASHION CHANNEL
QVC NETWORK INC.
RAI-USA
REUTERS NEWS-VIEW
RUSSIAN TELEVISION NETWORK INC.
SCI-FI CHANNEL
SCOLA
SHALOM AMERICA
SHEPHERDS CHAPEL NETWORK
SPORTSCHANNEL AMERICA
TELECOLOMBIA
THE TRAVEL CHANNEL
TRINITY BROADCASTING NETWORK
TURNER NETWORK TV
TV JAPAN
UNIVISION
USA NETWORK
VIDEO HITS ONE (VH-1)
VISION INTERFAITH SATELLITE NETWORK
THE WEATHER CHANNEL
WEB SPORTS WIRE
WGN-TV/UVI
WPIX NEW YORK
WSBK-TV BOSTON
WTBS ATLANTA
WWOR-TV NEW YORK

TEXT SERVICES

CABLE SPORTSTRACKER
THE ELECTRONIC PROGRAM GUIDE
ELECTRONIC PROGRAM GUIDE JR.
LIFE NEWSVISION
TMS BUSINESS PLUS
TMS NEWS PLUS
TMS SPORTS PLUS
UPI DATACABLE
X*PRESS EXECUTIVE
X*PRESS X*CHANGE

Source: *Television & Cable Factbook, Services Volume* at G-65 (1993 edition).

ATTACHMENT B

TABLE I
Hours Per Person Per Year Using Various Media
(1991)

Medium	*Hours*
Television (total)	1,515
Network Affiliated Stations	848
Independent Stations	265
Basic Cable	319
Pay Cable	83
Radio	1,115
Recorded Music	219
Daily Newspapers	169
Magazines	88
Books	98
Home Video	43
Movies in Theaters	9
Total	3,256

Source: *The Veronis, Suhler & Associates Communications Industry Forecast* at 12 (1992).

TABLE II

End-User Spending Per Person Per Year
For Various Media
(1991)

Medium	*Amount* ($)
Cable Television	84.13
Movie Box Office	23.03
Home Video	58.56
Recorded Music	37.57
Daily Newspapers	49.02
Books	67.83
Magazines	33.02
Total	353.16

Source: *The Veronis, Suhler & Associates Communications Industry Forecast* at 14 (1992). Broadcast television and radio are excluded from this comparison because they are supported entirely by advertising.

TABLE III

Advertising Expenditure by Medium
(1991)

Medium	*Amount* ($ Mil)
Television Broadcasting	24,110
Radio Broadcasting	8,450
Cable Television	1,985
Daily Newspapers	30,409
Magazines	10,635

Source: *The Veronis, Suhler & Associates Communications Industry Forecast* at 23 (1992). Media that are not supported in part by advertising, such as films, recorded music, and books are excluded from this comparison.

TABLE IV

Gross Media Expenditures
(1991)

Industry Segment	*Amount* ($ Mil)
Television Broadcasting	24,110
Radio Broadcasting	8,450
Cable Television	17,780
Movie Box Office	4,803
Home Video	10,995
Recorded Music	7,834
Daily Newspapers	39,612
Book Publishing	20,265
Magazine Publishing	18,335

Source: *The Veronis, Suhler & Associates Communications Industry Forecast* at 23 (1992). The expenditures included for this comparison include both end-user and advertising expenditures.

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF VIRGINIA
(Alexandria Division)

[Caption Omitted in Printing]

AFFIDAVIT OF RICHARD A. ALSTON

1. I am Vice President—Operations & Engineering for The Chesapeake & Potomac Telephone Company of Virginia ("C&P"). I have had extensive experience in network operations in my career over the past 21 years with C&P and with other parts of the former Bell System.

2. C&P is proposing to enhance its telephone network in Alexandria, Virginia to have the capability of carrying video programming upon the successful outcome of this litigation.

3. If C&P made these enhancements today, C&P would use a fiber optic system supplied by BroadBand Technologies, Inc., which carries both telephone calls and video signals on an integrated basis. C&P currently is using this system to carry the video programming of third parties at the Cascades development in Loudoun County, Virginia. A sister company of C&P, the New Jersey Bell Telephone Company, has announced that it will use this system to carry the video programming of third parties in several areas in New Jersey.

4. Using the BroadBand Technologies, Inc. system, C&P's network in Alexandria would have the capacity to provide several hundred channels of video programming to its telephone subscribers.

5. In addition, C&P's network would have the capability to deliver video programs on demand. This will allow consumers to select one of potentially hundreds of

movies or other programs from video libraries to view at any given time of the consumer's choosing.

6. If permitted by this Court, C&P would make these capabilities available to its affiliate, Bell Atlantic Video Services Company ("BVS"), so that BVS can provide video programming to subscribers in Alexandria. C&P would also make these capabilities available for use by other video programmers under tariff on a common carrier basis.

7. In providing these services, C&P will not exercise editorial control over the unaffiliated programmers that use its network—with the exception of the possible exclusion of pornography or other offensive material to the extent that such exclusion is permitted under common carrier regulation.

8. C&P, to the extent permitted by the FCC, may also offer some limited video programming of its own such as introductory menus or welcoming screens.

I declare under penalty of perjury under the laws of the United States of America that the foregoing is true and correct. Executed on April 27, 1993.

/s/ Richard A. Alston
RICHARD A. ALSTON

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF VIRGINIA
(Alexandria Division)

[Caption Omitted in Printing]

AFFIDAVIT OF DR. VIVIAN M. HORNER

1. I am Director of Bell Atlantic Video Services Company ("BVS") and part of the team that is developing video programming for BVS to provide in Alexandria and elsewhere.

2. I have more than thirty years of programming and communications experience, primarily in start-up ventures. Among other positions, I was formerly Vice President, Program Development, of Warner Amex Cable Communications, where I created several highly-successful video programming services, including Pinwheel (a channel for preschool children), Sight on Sound (the precursor of MTV), and Nickelodeon.

3. If permitted at the end of this case, BVS will provide video programming in Alexandria using the C&P telephone network. BVS will purchase capacity from C&P on the same tariffed terms as offered by C&P to others.

4. BVS will select and package some of its programming from the numerous cable programming networks that are available; it will also select some programming from various film libraries and from independent producers.

5. In addition, some programming may be produced exclusively for BVS by producers working under contract with BVS or by BVS employees themselves. Bell Atlantic has three broadcast-quality television studios located in

Silver Spring, Philadelphia, and Newark which BVS may use to produce programming.

6. BVS also will carry broadcast programming.

7. The programming that BVS will provide in Alexandria is based on a review of audience demographics and interests, community standards, and BVS's and my own editorial judgments. BVS will exercise editorial control over the programming that it provides.

8. BVS is currently engaged in discussions with a number of suppliers of video programming. No supplier that BVS has talked to has refused to supply programming. To the contrary, suppliers are eager to open up an alternative distribution channel.

9. BVS plans to provide programming that is not currently available in Alexandria. For example, BVS plans to carry several Spanish language channels such as Canal SUR, Galavision/ECO, Telemundo, and Univision. According to the 1990 census, 9.7% of Alexandria residents are Hispanic. The Alexandria Public Schools offer instruction in English as a second language; the largest block of students in these programs speak Spanish as their primary language. Jones carries only one Spanish language broadcast station (W48AC) and none of the other available Spanish language programming. As another example, BVS plans to carry WGN, a Chicago broadcast superstation that carries Cubs baseball games. According to a 1992 survey Jones conducted, Alexandria cable subscribers would like to receive WGN. Jones, however, does not carry it.

I declare under penalty of perjury under the laws of the United States of America that the foregoing is true and correct. Executed on 4/28/93.

/s/ Vivian M. Horner
DR. VIVIAN M. HORNER

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF VIRGINIA
(Alexandria Division)

[Caption Omitted in Printing]

AFFIDAVIT OF THOMAS W. HAZLETT

Thomas W. Hazlett deposes and says:

1. I am an Associate Professor at the University of California, Davis, where I teach economics and public policy. During the 1991-1992 academic year I served as Chief Economist of the Federal Communications Commisison. During the 1990-1991 academic year I was a Visiting Scholar at the Columbia Institute for Tele-Information at the Columbia University Graduate School of Business.

2. I received my Ph.D. in economics from UCLA in 1984 and have taught a variety of courses in micro-economics, finance, and public policy at the graduate and undergraduate levels. I have researched and written numerous academic articles on competitive and regulatory issues in the cable and broadcast television industries. The Appendix to this affidavit includes a list of my publications relevant to this affidavit.

Summary

3. In this affidavit I explain the fundamental changes that have transformed the cable industry in the years since the FCC promulgated the CATV ban in 1970 and even since 1984, when Congress codified it. The original ban dates back to a time when cable was still a fledgling industry, thought to be highly susceptible to dominance by telephone companies through their control of utility

poles and other rights-of-way needed for coaxial cable used to provide cable service. But today, following the passage of the Pole Attachment Act and two decades of sheltered growth, the cable industry has become a powerful monopolist in its own right, exercising market power over viewers and extracting monopoly profits that reduce the general flow of video programming. In these circumstances, permitting entry by the telephone companies can only lead to lower prices and increased output (*i.e.*, to more consumer choice and additional communication services).

The Existing Cable Companies Have Monopolized Local Video Distribution

4. Cable television systems generally operate as monopolies in the local markets in which they serve. These monopolies developed into dominant distributors of video programming largely over the last decade.

5. The cable industry was born in Mahanoy City, Pennsylvania in 1948. In the 1950s, the FCC twice declined to regulate cable systems as common carriers.[1]

6. In 1970, the FCC decided to shelter the infant cable industry from telephone company competition. Accordingly, the FCC prohibited telephone companies from providing CATV service. The FCC also took steps to facilitate cable company access to telephone company poles and conduits.[2]

7. Congress followed with the federal Pole Attachment Act of 1978.[3] This legislation authorized the FCC, in combination with state regulation, to regulate the rates

---

[1] *See* Lucas Powe, Jr., *American Broadcasting and the First Amendment* 218-220 (1987).

[2] *See generally* Siegel, *The History of Cable Television Pole Attachment Regulation*, 6 Comm. and the Law 9 (Dec. 1984).

[3] Pub. Law No. 95-234, Communications Act Amendments of 1978 (Feb. 6, 1978), *codified in* 47 U.S.C. § 224.

cable companies were charged for pole access.[4] The Commission established a mathematical formula for determining "just and reasonable" attachment rates,[5] and set up a procedure to encourage private resolution of most disputes.[6] Access remains, in principle, a matter of contract negotiation.[7] But mutually satisfactory contracts were soon hammered out.[8]

8. Cable television developed rapidly in the late 1970s and early 1980s. Major cable networks such as ESPN (1979), Nickelodeon (1979), and CNN (1980) were launched. Cable subscribership began to grow rapidly. Table 1.

9. A further impetus to investment in cable plant and in satellite networks was provided by the 1984 Cable Act, which deregulated cable rates, fully unleashing the industry to compete against broadcast television. Congress also incorporated into the Act a revised version of the FCC's ban on cable service.

---

[4] "[T]he Commission shall regulate the rates, terms, and conditions for pole attachments to provide that such rates, terms, and conditions are just and reasonable * * *." 47 U.S.C § 224(b)(1). The Act also provided that a state would not be considered to be regulating pole attachments unless it had issued rules and was acting promptly on complaints. *Id.* at § 224(c)(3).

[5] Subpart J. Pole Attachment Complaint Procedures, 47 U.S.C. § 1.1409(c).

[6] *Id.* at § 1.1404.

[7] *See FCC* v. *Florida Power Corp.*, 480 U.S. 245, 251 n.6 (1987). "CATV industry representatives" had testified "that access to utility poles does not in itself constitute a problem." S. Rep. No. 580, at 16.

[8] *National Cable Television Ass'n* v. *FCC*, 747 F.2d 1503, 1505, 1506 & n.1 (D.C. Cir. 1984). *See also* Telephone Company-Cable Television Cross-Ownership Rules, §§ 63.54-63.58, Telco Notice of Inquiry, 2 F.C.C. Rcd 5092, 5093-5094 (1987) (discussing ameliorating effect of the Pole Attachment Act).

10. The growth in distribution plant has also been dramatic. In 1970 cable was available to less than 10 percent of all American television households.[9] By 1984 it passed approximately 72 percent of all television households. Cable now passes 96 percent of television households. Subscribership to cable increased from less than 7 percent of all U.S. homes in 1970 to nearly 44 percent in 1984. By 1992, about 60 percent of U.S. households subscribed.[10] Programming distributed principally over cable systems began in 1972 with HBO. There were four national cable networks in existence in 1976. By 1984 this number had increased to 49 and by 1992 to 78. Table 2.

11. The cable industry benefitted enormously from deregulation. Capital values in the industry grew; average selling prices for cable systems rose from an average of $948 per subscriber in 1984 to $2,291 per subscriber in 1989. Table 3. While macroeconomic factors flattened asset values generally in 1990-1992, recent 1993 cable transactions indicate that per subscriber transactions are again well over $2,000.

12. It is now clear that by the late 1980s the cable industry had acquired substantial market power over the local distribution of video programming. The best evidence of this monopolistic profitability is found in the economic "Q-ratios." In a competitive industry, buyers won't pay much more to buy facilities than it would cost to build them from scratch. Thus, in a competitive industry, the market value of an asset is generally approximated by its replacement cost of capital. The Q-ratio is an economic measure based on this logic. The ratio is defined as:

> Q=Market Value/Replacement Cost of Tangible Capital

---

[9] Stip. 17.

[10] Stip. 17.

13. In the cable television industry, Q-ratios have been estimated at between 2.5 and 6.[11] These estimates are supported by basic facts. The typical cable network costs about $619 per subscriber to build.[12] Yet investors buying cable assets over the past five years have paid about $2,000 per subscriber, or about three times the price that a highly competitive firm would attract in the marketplace. In fact, the average Q-ratio for the firms listed on the New York Stock Exchange in February 1990 was only .85.[13] A 1990 Brookings Institute study of 20 industries over the 1961-1985 time period found an average Q-ratio of 1.28 throughout the 25-year time frame, and just one industry with a Q-ratio of more than 2.[14] And, in a study of Q-ratios conducted for the United States Telephone Association, Paul MacAvoy estimated that Q-ratios for GTE and the seven Regional Bell Operating Companies (including their cellular holdings) ranged from 1.1 to 1.3, with a weighted average of 1.2.[15]

---

[11] These estimates are summarized in Thomas W. Hazlett, *Duopolistic Competition in Cable Television: Implications for Public Policy*, VII Yale J. on Reg. 97-99 (Winter 1990).

[12] Capital costs are derived from a June 1986 Department of Justice, Antitrust Division, Economic Analysis Group paper by Albert Smiley. This is detailed in Thomas W. Hazlett, *Duopolistic Competition in Cable Television: Implications for Public Policy*, VII Yale J. on Reg. 98 (Winter 1990).

[13] *In re* Competition, Rate Deregulation and the Commission's Policies Relating to the Provision of Cable Television Service, 5 F.C.C. Rcd 4962, 4999 (1990) (MM Dkt. No. 89-600) (hereinafter FCC Cable Report).

[14] Lawrence F. Katz & Lawrence H. Summers, *Industry Rents: Evidence and Implications*, in *Brookings Papers on Economic Activity: Microeconomics* 214 (1989).

[15] MacAvoy noted that, excluding cellular holdings, the ratio would be closer to 1.0. *See* FCC Cable Report, 5 F.C.C. Rcd at 5074. As the FCC has observed, this ratio "reflects [the telcos'] status as regulated utilities." *Ibid.*

14. When cable companies face competition in their service areas, their monopoly power dissipates. Over the 1988-1992 period, there are twenty-one recorded sales transactions for cable companies in competitive (duopolistic) markets. They average 15-20 percent less on a per subscriber basis than contemporaneous sales of cable systems in monopoly markets. Table 4.

15. In response to widespread dissatisfiaction with rising cable prices, poor customer service, and complaints concerning monopolistic practices, the U.S. Congress enacted a cable re-regulation bill in 1992.[16]

16. The likely effects of this bill can be debated.[17] What is abundantly clear, however, is that virtually all the major policy discussion about the video distribution industry now centers on how to constrain cable's market power. Public concerns about cable's competitive viability have, due to changing market conditions, become entirely obsolete.

Head-to-Head Cable Rivalry Lowers Prices and Increases Output for Consumers

17. Compelling evidence of cable's power to raise rates due to a monopoly market structure comes from those few communities that have permitted and enjoyed head-to-head cable competition. There, prices are reliably lower and output (measured by subscribership or number of channels offered) is higher. In data released by the FCC in February 1993, 46 cable systems in head-to-

---

[16] Pub. Law No. 102-385 (Oct. 5, 1992), *codified in* 47 U.S.C. § 521.

[17] I have argued elsewhere that the "reregulation" portion of the 1992 Act is not likely to be effective, although the rules attempting to open up local markets to competition are a step in the right direction. *See* T. Hazlett, *In Cable War, Consumers Get Snagged*, Wall St. J., Oct. 2, 1992 (op-ed page); T. Hazlett, *Cable Reregulation: The Episodes You Didn't See on C-SPAN*, Regulation Magazine, 1993 (forthcoming).

head competitive markets were found to have charged basic prices of just $0.41 per channel, contrasted to a rate of $0.65 per channel on monopoly systems. Cable systems that faced competition featured both lower basic cable rates and more channels. Table 5.

18. Several earlier surveys have found similar results. In 1990, the FCC surveyed a number of competitive systems, and found that their rates were 34 percent below monopoly system prices on a per channel basis.[18] The Commission was led to conclude that "direct competition has resulted in reduced per channel rates for cable service."[19] In a 1990 econometric study, Levin & Meisel found basic cable prices from 22 percent to 30 percent lower for a service which "typically includes more channels."[20] And, while difficult to measure, narrative accounts strongly suggest that customer service in competitive markets is also superior.[21]

19. Data from Paul Kagan Associates further support the price-lowering effect of head-to-head rivalry. In an April 1992 survey of 103 systems competing in 50 separate cable markets and serving 1.13 million households (about 2 percent of the U.S. cable total), the average revenue per subscriber was $25.08,[22] while the average number of channels offered on basic was 40. The

---

[18] FCC Cable Report, 5 F.C.C. Rcd 4962, at App. H-2.

[19] *Id.* at 5014.

[20] Stanford L. Levin & John B. Meisel, *Cable Television and Telecommunications: Theory, Evidence and Policy*, Telecommunications Policy, Dec. 1990, at 519-528.

[21] Daniel R. Levine, *Behind the Cable Rip-off: It's Time to Pull the Plug on Price-Gouging Monopolies and Get a Little Healthy Competition into the Picture*, Reader's Digest, June 1992; Mark Lewyn & Julie Ampano Lopez, *More Choice for Cable TV?*, Business Week, May 13, 1991.

[22] Kagan breaks down the data into "incumbent" and "overbuilder" categories. The figures used here are equally weighted averages of the two.

average monthly revenue per subscriber for all U.S. cable systems in 1992 was $32.12 (Table 1) and the number of basic channels offered was under 35 (Table 5), implying that competitive systems were pricing their total service package about 21.9 percent lower, while providing greater viewing choices. Table 6.

20. Incumbent cable companies respond dramatically to new competition. When an entrant begins constructing a competing system, the incumbent typically cuts subscriber rates just in those areas (literally, the blocks) where the competitor has placed its lines. Prices have been dramatically lower in areas where rivalry has been in evidence, a sign that prices prior to entry were above competitive levels. Telesat Cablevision, for example, entered the cable market against entrenched competitors in Orange County, Florida. In April 1992, the prices charged by the two firms against which Telesat competed (in different areas of Orange County) were far lower than the prices they charged in their monopoly markets. Table 7.

21. In sum, the evidence is overwhelming that a monopoly market structure allows cable firms to charge consumers higher prices than otherwise. Cable's Q-ratios, prices in cross-sectional studies, prices in time series, and system sales prices under competitive vs. monopoly market structures all point in exactly the same direction: cable firms that face no direct competition from head-to-head cable competitors have significant market power which they utilize to raise rates and restrict output from competitive levels.

Jones Intercable Enjoys a Monopoly Position in Alexandria, Virginia

22. Jones Intercable enjoys a market position in Alexandria, Virginia typical of cable franchisees elsewhere in the country. As the sole cable television system in the city, it enjoys a Q ratio significantly above 1. In fact,

in an intracompany transfer in 1992, Jones paid $2,134 per subscriber.[23] The purchase price is clearly in excess of capital replacement costs, particularly considering that the density of households is more than *twice* the national average (thus reducing plant investment per subscriber).

23. Jones' rates in Alexandria, where it does not face head-to-head cable competition, are significantly higher than in Anne Arundel, Maryland, a market in which Jones does face a direct cable competitor.[24] The monthly price of the basic cable package in Alexandria is $24.65, and includes 44 channels of programming. In Anne Arundel, Jones charges $21.20, and offers subscribers either 43 or 53 channels, depending upon where they live.[25] This indicates that prices in the competitive market are between 8 percent and 29 percent lower on a per-channel basis. Such downward pressure on prices reliably expands the consumption of any product. The relative cable subscribership rates in Alexandria and Anne Arundel are consistent with this. Cable subscribership in Alexandria is only 57 percent, which is less than the national average. In Anne Arundel County, cable subscribership is over 70 percent, well above the national average.[26]

24. A comparison of the prices Jones charges in Alexandria with national averages compiled by the FCC (see Table 4) reveals that Jones charges about 37 percent more per channel for basic services in Alexandria than do cable companies that face head-to-head competition. This despite the fact that the density of households in

---

[23] Dean Witter Reynolds, Company Report—Jones Intercable Investor, L.P. 4 (Oct. 22, 1992). The report claims that the "[p]rice paid for Alexandria Systems seems low." *Ibid.*

[24] The competitor, United Cable and its predecessors, have competed with Jones for more than a decade by virtue of each company holding a non-exclusive cable franchise.

[25] Stip. 34.

[26] Stip. 35.

Alexandria is more than twice the national average, which substantially reduces plant investment per subscriber.

Direct Cable Competition is Financially Viable

25. Cable monopolies dominate local video markets not due to an efficient market structure, which realizes scale economies for the benefit of consumers. Quite the contrary: cable companies currently charge prices far in excess of their average costs, as well as the likely costs of competitors. New entrants could charge lower prices and still realize profits. Head-to-head cable competition is viable in most local cable markets at existing prices, and even at prices much reduced from current monopoly levels.

26. Video programming currently available vastly exceeds the carrying capacities of existing cable systems. There are roughly 80 national programming networks currently available.[27] In total, over 150 channels of cable programming are now available.[28] (There would be an even larger number of such services on the market if cable were more competitive at the local distribution level.) Yet, of the 11,083 cable systems operating nationwide, only 1,152 systems or 10 percent of these systems carry more than 53 channels; over half the systems offer 30-53 channels; the remaining 35 percent offer fewer than 30 channels.[29]

27. My 1992 financial analysis of "overbuild" competition in cable sought to gauge the financial viability of competition in a typical U.S. cable market. I estimated expected rates of return for a new competitive cable system entering a market already served by one cable system, and possessing the following characteristics:

---

[27] NCTA, Cable Television Developments 7-A (Mar. 1993).

[28] *Extra!*, Satellite Orbit Magazine, Mar. 1993.

[29] NCTA, Cable Television Developments 10-A (Mar. 1993).

50,000 homes; density (homes per mile of cable plant) of the U.S. average; revenue per subscriber of the U.S. average; subscribership of the U.S. average (with no increase attributable to competition); aerial to underground wiring ratio equal to the national average; revenue growth of 5 percent per year.[30] I assumed the firm's capital costs to be those listed as standard in a 1986 paper from the U.S. Department of Justice (the quality-adjusted cost of physical capital has been declining over time), operating costs to be 57.1 percent of revenues (the national average), and that the new entrant would garner a 50 percent market share but that no additional households would subscribe to cable (*i.e.*, the new firm would serve 50 percent of existing cable customers). Based upon this analysis, a new competitor could expect a return of 18 percent at average U.S. rate levels existing in 1991. Even allowing for a 20 percent fall in rates due to competition (and a corresponding increase in subscribership of 20 percent), a new entrant earns 16 percent. Since the model uses conservative assumptions,[31] and both numbers are above the cost of capital, this indicates that the typical cable market is financially capable of supporting two rival cable firms.

Direct Cable Competition is Financially Viable in Alexandria, Virginia

28. Alexandria, Virginia is particularly attractive from the standpoint of cable competition. The key variable to focus on in assessing financial viability is revenue per mile of plant: cable entrants must be able to anticipate

---

[30] Thomas W. Hazlett, *Telco Entry Into Video*, paper presented to the Public Utility Research Conference, University of Florida (Apr. 1992).

[31] The cable industry, for instance, anticipates revenue growth above 5 percent; competition does increase subscribership, etc.

sufficient cash flows to sustain their fixed investments, largely constituted by laying the transport grid (*i.e.*, cables). Alexandria cable consumers now pay an average of $34.92 per month, well above the 1992 U.S. average of $32.12 (see Table 1). Moreover, the density of the market, 244 homes per mile, is *two and a half times* the U.S. average of 93. These two factors combine to make this particular market a likely candidate for head-to-head cable competition.

29. The 1990 Annual Report of Jones Intercable says virtually as much itself, in describing its Alexandria, Virginia market in glowing terms:

> Alexandria, Virginia * * * is a relatively stable, affluent community with excellent demographics, including a high rate of employment and one of the highest levels of population density in the Washington metropolitan area. The current population of Alexandria is approximately 112,000, with a median household income above the national average at approximately $42,600. More than 75 percent of Alexandria residents are employed in white-collar occupations, with 40 percent of those employed working in managerial and professional positions. Historically, these demographics have proven to be highly favorable for cable subscriptions and penetration rates.[32]

Telephone Companies are Important Potential Competitors in the Cable Market

30. Competition is economically possible in cable markets, but cable companies have proven very adept at blocking it. As noted above, favored cable strategies include aggressive and highly selective price discrimina-

---

[32] Jones Intercable, 1990 Annual Report 6 (Dec. 31, 1990).

tion, exclusive contracts with programmers, and monopolization of the franchising process.[33]

31. In a market occupied by such powerful and aggressive incumbents, widespread competition must feature new entrants which begin with both technical sophistication and substantial financial resources. The telephone companies are the most likely such competitors. Certainly this has been the view of the cable incumbents, which have routinely targeted retention of the telco video programming ban as their top legislative priority.[34]

32. There are no technical barriers to head-to-head competition in the provision of video programming between telcos and cable providers. Cable does not utilize airwaves that are parcelled out by a regulatory body. Competing cables can be laid side by side. In fact, on a common carrier network such as C&P has indicated that it intends to build, competing video programs can be carried on the same wire.

33. Moreover, the 1978 Pole Attachment Act has fulfilled its purpose. U.S. cable markets have been wired by independent (non-telco) companies, including the Alexandria, Virginia market. Most utility poles and conduits are owned not by telephone companies but by other utilities,[35] and these utilities may and do provide cable tele-

---

[33] A litany of abusive practices employed by cable incumbents, and their trade associations, to deter competitive entry was detailed by the largest such competitor, Telesat Cablevision in comments to the FCC. *See* Comments of Telesat Cablevision, Inc., *In re* Competition, Rate Deregulation and the Commission's Policies Relating to the Provision of Cable Service, MM Dkt. No. 89-600 (F.C.C. Mar. 1, 1990).

[34] As a leading cable industry analyst, John Mansell, noted in 1988: "Needless to say, cable's number one priority is the continuance of the telco/cable cross ownership bar." Cable Television Franchising, Aug. 31, 1988, at 2.

[35] Stip. 23 ("Nationally, electric utilities own more poles than telephone companies."); in Alexandria, Virginia, C&P provides

vision service themselves,[36] in competition with cable companies. Municipalities, which control all public rights of way over and under the streets, are likewise permitted to operate their own cable systems,[37] and many do.[38] Nonetheless, independent cable companies have successfully deployed their own cables, even against this class of favorably positioned potential competitors.

Competition Against Cable Monopolists Would Lower Price, Increase Output, and Increase Diversity in Video Programming

34. There is today no plausible economic scenario according to which telco competition against incumbent cable monopolists would raise price or reduce the total amount of video programming offered to consumers. Competition reliably lowers prices for cable customers and thereby enlists greater numbers of subscribers; this constitutes an increase in diversity of programming as cable subscribers have access to many more video choices than non-cable customers.

35. In 1970, when the FCC first prohibited telephone companies from providing CATV service, cable was an infant industry. The FCC assumed (not unreasonably at the time) that by sheltering that industry from telco competition it could promote the development of a competing distribution notework.

2,744 poles and VEPCO, the local electric utility, provides 4,639 poles. Stip. 24.

[36] Stip. 26.

[37] *See* 47 U.S.C. 533(e)(1), 47 U.S.C. § 541(f). *See also Warner Cable Communications Inc.* v. *City of Niceville*, 911 F.2d 634, 637 (11th Cir. 1990) (No. 89-3273).

[38] As of 1992, 63 municipalities provide cable service through municipally owned cable systems. Stip. 25.

36. The new network has since developed, more successfully than the FCC might have imagined in 1970. Indeed, the cable industry has passed competitive maturity: it now monopolizes local video distribution.

37. As technology advances, the separation of telephone and video service becomes increasingly artificial. The marketplace surely reflects this, as cable companies are now actively seeking to provide voice telephone service in competition with existing telephone companies. For example, cable companies are rapidly building alliances with "competitive access providers" (CAPs), who run independent, usually fiber-optic, networks, typically through major urban centers, connecting businesses to each other and to long distance carriers. Overall, cable interests now control over 50 percent of CAP revenues.[39] At the same time, cable companies account for more of the experimental "personal communications service" (PCS) licenses issued by the FCC than all seven Regional Bell companies combined.[40] Jones Lightwave Ltd., an affiliate of Jones Intercable, has FCC experimental licenses for PCS trials in Alexandria, Virginia, and in Illinois, Florida,

---

[39] The Yankee Group, CAP Market Update: Year of Transition 6 (Feb. 1992). For a non-exhaustive list of cable-CAP interests, see Stip. 49.

[40] Office of Engineering and Technology, FCC, PCS Experimental Applications by Filed Date (Mar. 1, 1993). *See also* Stip. 55. The nation's first coast-to-coast PCS phone call was placed through a cable television system in February 1992; many cable companies are using FCC experimental licenses to test PCS. The cable industry, according to its own publicity, "is well-suited to linking PCS radio-relay (cell) sites because cable passes 96 percent of U.S. homes." NCTA, Press Information, Cable Television Year in Review: 1992, at 3 (Nov. 24, 1992). *See also* NCTA, Cable Television: Bringing Fiber Optics to America 4 (Feb. 1992) ("The cable industry's vision anticipates that additional service capabilities will be developed under this design through interconnection with other communications technologies and services, such as Personal Communications Services * * *.").

and Colorado.[41] TCI, the nation's largest cable operator, predicts that cable systems will be capable of providing telephone service by the mid to late 1990s, using upgrades to cable networks that are already being deployed.[42]

38. With the current baseline of monopoly prevailing in the overwhelming number of cable markets, as well as in the specific market of Alexandria, Virginia, allowing a new entrant to compete cannot lessen consumer choice. This is true even if one assumes the worst: after some period of intense competition, a telco entrant eventually displaces the current monopolist. While highly unlikely (and remediable by several alternative means other than a blanket ban on video programming by telcos) even this worst case entails expanded consumer choice during the rivalrous stage, and no lessened choice in settling back to a monopolistic Square One. Because of the prevalence of sole supplier cable markets, we cannot do worse than we presently do.

39. The only relevant questions, then, are: How much will choice improve with new entry? And for how long?

40. The evidence on the first question is unmistakable: wherever and whenever competition does come about, consumer choices improve dramatically. First, prices fall, allowing more consumers to avail themselves of the video choices of the new technology. Second, competition supplies more video programming, more choice, more diversity. This is revealed in the substantially higher number

---

[41] Stip. 56; FCC Experimental License Nos. 2429-EX-PL-92, 2430-EX-PL-92, 2431-EX-PL-92, 2432-EX-PL-92.

[42] Joanne Kelley, *Tele-Comm Unfurls $2.0 Billion Network Plan*, Reuters, Apr. 1, 1993. One cable company executive even claims that cable companies will soon offer basic cable service free to households that would otherwise decline to subscribe in order to promote the sale of telephone and other services. *Record CAB Attendance*, Communications Daily, Apr. 8, 1992, at 3 (quoting Amos Hostetter, Chairman of Continental Cablevision).

of program channels which competitive cable systems provide.

41. The cable industry's argument is that these beneficial effects will not endure in the long run. That is uncompelling in that some competitive period is preferred to none. Moreover, both economic theory and real world experience indicate that competition can and will endure.

42. The incumbent cable monopolists have invested in long-lived physical plant. Many are upgrading to fiber, which will last even longer. In economic jargon, these investments are already "sunk." Once the money has been spent, it is largely unsalvageable. Looking forward, then, the *future* cost of these facilities is close to zero. New entry by telcos cannot possibly deter competition by others when that long term commitment has already been made. The only realistic exit from the market, once significant costs have been sunk, is via merger—and that would take an explicit approval by the antitrust authorities.

43. Cable industry reaction to possible telephone company entry into video offers powerful testimony to the likely long-lived impact of telco-cable competition. Nationally, the cable industry is quickly upgrading its facilities, particularly with fiber optic investments, to prepare for the possibility of the telephone company competition they fear. The cable companies are thus signalling that they believe the entry of telcos into the market would result in more competition which justifies the sinking of durable capital. Indeed, since the filing of the lawsuit of which this affidavit is a part, Jones has had informal discussions with the City of Alexandria wherein it has offered to make additional investments in channel capacity in Alexandria if it receives a 20-25 year non-exclusive franchise.[48]

44. We cannot do any worse than monoply. There can be a debate over the magnitude of consumer im-

---

[48] Stip. 89.

provement with new entry, but not of the direction. Prices will fall some amount, for some period. Choices will increase, by some amount for some time. There is simply no dispute: when one begins with monopoly, new entry can only increase the amount of consumer choice.

I declare under penalty of perjury under the laws of the United States of America that the foregoing is true and correct. Executed on this 29th day of April, 1993.

/s/ Thomas W. Hazlett
THOMAS W. HAZLETT, PH.D.
Associate Professor
University of California
Davis, CA 95616-8512

Table 1. Cable Industry Trends.[1]

Year	House holds Subscribing to Cable (thousands)	Total Revenue ($ millions)	Revenue/ Subscriber/ Month ($)	Availability (Homes Passed/ Households) (%)	Penetration (Subscribers/ Homes Passed) (%)	US TV Households (%)
1960	750	50	5.56	N/A	N/A	1.4
1970	5,100	345	5.64	<10.0	N/A	6.6
1980	17,671	2,549	12.02	45.7	55.1	25.2
1984	37,290	7,800	17.43	72.0	56.5	43.7
1992	55,200	22,000	32.12	96.0	62.0	60.0

Table 2. Cable Network Growth.[2]

Year	Number of Networks
1970	0
1976	4
1984	49
1992	78

[1] The Kagan Cable TV Financial Databook 18 (June 1989); NCTA, Cable Television Developments 1-A, 2-A, 8-A (Mar. 1993); National Telecommunications and Information Administration, Dep't of Commerce, Video Program Distribution and Cable Television: Current Policy Issues and Recommendations 10 (June 1988); Florence Setzer and Jonathon Levy, FCC, OPP Working Paper 26, Broadcast Television in a Multichannel Marketplace 68 (June 1991); Paul Kagan Assoc., Cable TV Investor 5 (Feb. 12, 1993); Stip. 17.

[2] Stip. 9; NCTA, Cable Television Developments 7-A (Mar. 1993).

Table 3. Sales Price Data for U.S. Cable Systems, 1982-1992.[3]

Year	Number of Systems Sold	Total Subscribers	Price/Home Passed ($)	Price/ Subscriber ($)
1982	212	934,071	486	922
1984	295	3,023,144	520	948
1989	379	5,951,353	1,255	2,291
1990	105	531,207	1,277	2,049
1991	111	4,523,433	961	1,795
1992	97	1,876,754	1,023	1,768
1993 Jan.-Feb.	5	232,000	N/A	2,848

Table 4. Competitive Cable Systems Sales Prices, 1988-1992.[4]

Year	Sample Size (systems)	Sample Size ($ million sales)	Price/ Subscriber ($)	Price/ Subscriber ($) (U.S. Mean)*	Price vs. Monopoly (%)
1988	9	35.905	1,649	1,953	−18.5
1989	8	170.229	1,886	2,351	−19.7
1990	2	7.325	1,638	2,047	−20.0
1991	1	5.200	1,300	1,569	−17.1
1992	1	55.500	1,500	1,768	−15.1

[3] Paul Kagan Assoc., Cable TV Investor 13 (Jan. 25, 1993); Paul Kagan Assoc., Cable TV Investor 6 (Feb. 12, 1993).

[4] Paul Kagan Assoc., Cable TV Franchising News Roundup (June 28, 1991). Figures for 1992 are from Paul Kagan Assoc., Private Cable Investor 1 (Mar. 31, 1993).

* Prices per subscriber for U.S. average differ from those given by Kagan in Table 3, and may be due to different weighting of sales data (*e.g.*, by system rather than by subscriber size).

Table 5. Competitive vs. Monopolistic Cable Rates from Current FCC Data.[5]

	Sample Size (systems)	Mean Basic Price/Month ($)	Mean Basic Channels (#)	Price/ Channel ($)
Monopoly	296	22.49	34.75	0.65
Competitive	46	19.02	46.59	0.41

Table 6. Competitive vs. Monopolistic Cable Systems Summary Statistics from 1992 Kagan Data.[6]

	Sample Size (Subscribers) (millions)	Mean Revenue/ Subscriber/ Month ($)	Mean Basic Monthly Rate ($)	Mean Basic Channels (#)	Monthly Price/ Channel ($)
Monopoly	54.89	32.12	19.08	35 *	.55
Competitive (103 systems)	1.13	25.08	17.49	40	.44
Price/Quality Difference vs. Monopoly		−21.9%	−8.3%	+14.3%	+19.8%

[5] Federal Communications Commission, Release of Data from Cable TV System Operators Rate Structure Questionnaire) (Feb. 24, 1993); Communications Daily, Mar. 4, 1993, at 2-3. As defined here, "basic cable" includes both Tier 1 (generally known as "limited basic") and Tier 2 (what most consumers call "basic").

[6] Paul Kagan Assoc., Cable TV Franchising News Roundup (June 28, 1991); Paul Kagan Assoc., Cable TV Franchising 4 (Apr. 30, 1992); NCTA, Cable Television Developments 1-A (Mar. 1993).

* See Table 5.

Table 7. Monthly Cable Rates in Competitive vs. Non-Competitive Areas ($).[7]

		ATC		Cablevision Industries	
Service	Telesat	Competitive	Non-Competitive	Competitive	Non-competitive
Basic ($)	17.95	13.95	20.70	11.95	18.95
Additional Outlets ($)	0.00	0.00	4.95	0.00	3.50
Remote Control ($)	0.00	0.99	4.00	0.00	4.00
Pay Channel ($)	9.95	8.95	11.60	7.45	10.00
Installation ($)	0.00	0.00	49.95	0.00	50.00

[7] Paul Kagan Assoc., Cable TV Franchising News Roundup 3 (Apr. 30, 1992).

* One-time connection charge.

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF VIRGINIA
(Alexandria Division)

[Caption Omitted in Printing]

JOINT STIPULATIONS OF FACT

For purposes, and solely for purposes, of this litigation, the parties, through undersigned counsel, hereby stipulate to the following facts:

A. *Stipulations Proffered By Plaintiffs* [1]

1. The Chesapeake and Potomac Telephone Company of Virginia (C&P) is a wholly owned subsidiary of Bell Atlantic Corporation. Bell Atlantic is privately owned and has over a million shareholders.

2. C&P is one of the telephone companies in the United States that is subject to common carrier regulation under title II of the Communications Act of 1934 and also state laws.

3. Fiber optic technology is capable of providing telephone service and transmitting video programming on an integrated basis directly to subscribers.

4. In 1984, no telephone company provided transport of video programming to subscribers over its telephone lines.

5. C&P carries the video programming of third parties at the Cascades, a development in Loudoun County,

---

[1] Although the parties proffering each series of stipulations have been identified, the parties acknowledge that each stipulation herein was subject to negotiation and modification by all parties prior to agreement.

pursuant to the FCC's *Order and Authorization*, File No. W-P-C-6649 (Jan. 11, 1991). C&P carries the video programming of third parties in Northern Virginia pursuant to the FCC's *Order and Authorization*, File No. W-P-C-6834 (Mar. 25, 1993).

6. As an information service provider, C&P provides its own voice and data messages, and messages of its affiliates, to the public. These services include, for example, time of day and weather services, Enhanced 911 service, and home shopping services.

7. Bell Atlantic Video Services Company (BVS) is an affiliate of C&P, incorporated in Virginia on September 24, 1992, for the purpose of providing video programming to the public.

8. In 1991-1992, 43 percent of viewing time in households that subscribe to cable was devoted to basic cable program networks and pay cable services.

9. In 1976, there were four national cable video networks in existence; in 1984, there were 49 national cable video networks; in 1992, there were 78 national cable video networks. In 1984, expenditures by cable systems to obtain programming were approximately $1.74 billion; in 1992, cable system expenditures to obtain programming were approximately $3.8 billion.

10. According to FCC, Office of Plans and Policies, *Broadcast Television in a Multichannel Marketplace*, OPP Working Paper No. 26 at 19 (June 1990), the average U.S. television household watches television approximately seven hours a day.

11. According to *The Veronis, Suhler & Associates Communications Industry Forecast* at 12 (1992), in 1991, the average U.S. resident spent 1,515 hours watching television, 1,115 hours listening to radio programming, 43 hours watching prerecorded videos at home, 9 hours watching theater movies, and 169 hours reading daily newspapers.

12. Statistics compiled by the Census Bureau show that 98% of U.S. households had a television set as of 1991.

13. Statistics compiled by the FCC and the Census Bureau show that 93% of U.S. households subscribed to telephone service as of 1991.

14. According to Sara Fritz & Dwight Morris, *Handbook of Campaign Spending: Money in the 1990 Congressional Races* 53, 54 (Congressional Quarterly 1992), in the 1990 election, 29 percent of the money spent by Congressional candidates went for radio and television advertising and media consultants. On average, radio and television advertising accounted for 35 percent of the money spent by Senate candidates and 23 percent of the money spent by House candidates. Congressional candidates spent about $119 million on broadcast advertising in the 1990 election.

15. NCTA and several of its members filed actions claiming that Sections 4 and 5 of the Cable Television Consumer Protection and Competition Act of 1992 violate their First Amendment rights and that Section 6 should be set aside as inseverable from Sections 4 and 5. *See National Cable Television Association, Inc. v. United States*, Civil Action No. 92-2495 (D.D.C.) and consolidated actions, Nos. 92-2247, 92-2292, 92-2494, 92-2558. One of NCTA's members has filed an action claiming that Sections 3, 7(b)(4)(B) and (C), 9, 10(d), 11, 15, 19, 24, and 25 of the Cable Television Consumer Protection and Competition Act of 1992, and Sections 611 and 612 of the Cable Communications Policy Act of 1984 violate its First Amendment rights. *Time Warner Entertainment Corp., L.P. v. FCC*, Civil Action No. 92-2494 (D.D.C.).

16. In 1986, Jones's price for basic cable service in Alexandria, which included 27 channels of programming, was $11.00 per month.

17. In 1970, according to the FCC in *Telephone Company-Cable Television Cross-Ownership Rules*, 7

FCC Rcd 5781, 5848 (1992), and the Census Bureau, *Statistical Abstract of the United States 1992* at 551, Table 884 (112th ed. 1992), cable passed less than 10% of all television households. In 1976, cable passed approximately 33% of all television households. In 1984, cable passed approximately 72% of all television households. Cable now passes approximately 96% of television households, and approximately 60% of television households subscribe.

18. In Alexandria, Jones Intercable, which is presently the sole provider of cable service in Alexandria, passes over 90% of all television households, and 57% subscribe.

19. Currently, the supply of available video programming exceeds the available channel capacity of almost all cable systems.

20. Cable systems presently have an average capacity of about 40 channels. In 1992, 88% of cable systems had fewer than 54 channels; however, approximately 35 percent of all subscribers were served by systems with 54 or more channels.

21. In Alexandria, Jones Intercable presently has a capacity of 51 channels.

22. In October 1979, C&P entered into an agreement with a predecessor to Jones which provided for the placement of cable facilities on C&P poles and in C&P conduit in Alexandria. This agreement was assigned to Jones when it acquired the cable system in 1986. The Alexandria cable system Jones acquired had been deployed sometime prior to Jones's acquisition; C&P has not provided any additional pole attachments for this system since 1984; and, since Jones acquired the system in 1986, Jones has not asked C&P to provide any new pole attachments.

23. Nationally, electric utilities have more poles than do telephone companies.

24. In Alexandria, C&P currently provides 2744 pole attachments to Jones and VEPCO, the local electric utility, provides 4639 pole attachments.

25. According to the Public Power Directory, there are 63 municipally-owned cable television systems in the U.S. Of these communities, 38 also have a municipally-owned electric system.

26. Florida Power & Light Co. currently operates a cable system in the same locality where it provides electric utility service.

27. According to the Census Bureau, annual cable operator revenues in 1970 were $345 million. In 1976, annual cable operator revenues from subscriber services including advertising were approximately $933 million. In 1984, annual cable operator revenues were approximately $7.8 billion. In 1992, annual cable operator revenues were approximately $21.5 billion.

28. Of the approximately 10,000 communities served by cable, as of 1991, 53 communities had more than one competing cable system in the same locality.

29. Some cable systems serving individual communities are owned by national or regional chains, known as multiple system operators (MSOs). The five largest MSOs combined serve 41.4% of all cable subscribers.

30. According to the Newspaper Association of America, *Facts about Newspapers '92* at 26 (1992): Some newspapers serving individual communities are also owned by national or regional chains. Daily newspapers are published in 1,513 cities. One hundred and thirty-three newspaper groups own 1,213 daily newspapers, or about 75% of all U.S. daily newspapers. Eighty-two groups own five or fewer daily newspapers; 51 groups own six or more daily newspapers. There is competition between daily newspapers under separate ownership in 37 cities. In 19 of these 37 cases, the competitors are published under joint operating agreements under an exemption from the antitrust laws.

31. Some of the companies that operate multiple cable systems and their 1991 revenues from all sources are: Tele-Communications, Inc. which serves 9.6 million cable subscribers and had total revenues of $3.8 billion; Time Warner which serves 6.8 million cable subscribers and had total revenues of $12 billion; Continental Cablevision which serves 2.8 million cable subscribers and had total revenues of $570 million; Comcast which serves 2.8 million cable subscribers and had total revenues of $720 million; Cablevision Systems which serves 2 million subscribers and had total revenues of $603 million; and Cox which serves 1.7 million subscribers and had total revenues of $2.3 billion.

32. Including its affiliates, Jones Intercable is the eighth largest multiple cable system operator in the U.S. with 1.5 million cable subscribers. Jones believes that it is the world's largest cable management company. Cable management companies operate cable systems they do not own.

33. Jones Intercable currently provides cable service in competition with another cable company in Anne Arundel County, Maryland.

34. As of April 1993, Jones charges $24.65 per month in Alexandria for a 44-channel package of programming. In Anne Arundel County, Jones charges $21.20 for either a 53-channel package of programming in areas where its system has been upgraded, or the same amount for a 43-channel package where its system has not yet been upgraded.

35. Cable subscribership in Alexandria is approximately 57%. Cable subscribership in Anne Arundel County is over 70%.

36. According to an April 1, 1993 FCC News Release, the price per channel of programming offered by competing cable systems is lower than the price where cable systems do not compete.

37. There are no absolute physical barriers to the construction of competing multichannel cable services at-

tributable to the physical scarcity of the electromagnetic spectrum. This is true generally and in Alexandria.

38. In delivering video programming of third parties in Northern Virginia pursuant to the FCC's *Order and Authorization*, File No. W-P-C-6834 (Mar. 25, 1993), C&P does not use the electromagnetic spectrum.

39. Both before and after this case was filed, Jones Intercable has had informal discussions with the City of Alexandria and has offered to make additional investments in channel capacity in Alexandria if it received a 20-25 year nonexclusive franchise. These discussions began before this case was filed.

40. Currently, both coaxial cable and optical fiber are used for wireline transmission of cable system video signals. Previously, only coaxial cable was used for this purpose. In general, multiple lines of coaxial cable or fiber optics can be placed next to each other without mutual interference to video signals they carry. This means competing cable transmission systems can exist side-by-side without such interference.

41. Originally, cable systems were primarily designed to provide one-way video signals. The newest cable system architecture is capable of supporting two-way telephone and data services.

42. According to the NCTA, looking solely at subscriber plant (i.e., not counting connections between exchanges or adjacent cities), in 1991 the regional Bell telephone companies installed approximately 8685 miles of fiber optic cable, while cable companies installed approximately 6408 miles of fiber optic cable. In a speech at the 1992 NCTA annual convention, the President of the NCTA stated that "Cable is now installing optical fiber at an annual rate that is 74 percent of what the RBOCs are doing. And we're gaining fast."

43. In a speech at the 1992 NCTA annual convention, the President of the NCTA stated that "[t]he biggest telecommunications story of the decade may turn out to be

not telcos' creating broadband networks, but cable technology and architecture proving to be the most efficient means of delivering the next generation of communications services."

44. In September, 1992, Comcast, the fifth largest multiple system operator and the current provider of cable service and one of the two cellular radio services in Philadelphia, placed an international telephone call from Philadelphia to London without the use of local wireline exchange services at the originating end in the United States.

45. Some cable companies in the U.K. are providing integrated video programming and telephone service in direct competition with the telephone company in the U.K., British Telecom.

46. In 1990, approximately 30% of the operating revenue of U.S. local exchange carriers came from the provision of "access services," *i.e.*, services that local telephone companies provide to long distance companies to connect local subscribers with the facilities of the long distance carriers at the originating and terminating ends of long distance calls.

47. So-called Competitive Access Providers ("CAPs") have entered the interstate access market in recent years, serving the needs of large, communications-intensive businesses, predominantly in metropolitan centers, that generate high volumes of long-distance telephone traffic. CAPs generally deploy fiber-optic facilities or, in some cases, microwave systems. It is estimated that the CAPs have invested hundreds of millions of dollars in their facilities.

48. Metropolitan Fiber Services, a CAP, competes with C&P in portions of Northern Virginia for the provision of interstate access services to the types of customers referred to in Stipulation 47.

49. Several members of NCTA have purchased interests in companies that provide interstate access services

in competition with local telephone companies. These include, but are not limited to:

a. TCI and Cox own Teleport, a CAP that provides service in New York, New Jersey, and Chicago, among other places. Comcast and Continental Cablevision have each agreed to purchase 20% equity interests in Teleport subject to regulatory approval.

b. Comcast owns 54% of Eastern Telelogic, a CAP that provides service in Philadelphia.

c. TCI has applied for authority to acquire Penn Access Corporation, a CAP that provides service in Pittsburgh.

d. Affiliates of Jones Intercable presently provide CAP services in two U.S. cities.

50. Southwestern Bell, which provides telephone service in the southwestern United States, has announced plans to purchase two cable systems in the Washington metropolitan area.

51. Southwestern Bell currently provides cellular radio service in Northern Virginia and the Washington-Baltimore metropolitan area.

52. The FCC licenses wireless telecommunications services. In the 1980's, the FCC licensed cellular mobile telephone services which overcame the need for wired connections between a subscriber and a telephone company switching center. The FCC licensed radio spectrum to two competing providers in each cellular service area. By regulation, one of the two competing providers initially was the local wireline telephone exchange carrier.

53. There are now 11 million subscribers in the United States to cellular service and their number continues to grow. In 1992, the number of cellular subscribers grew by over 40 percent. The cellular industry is now converting to digital technologies that will expand the carrying capacity of their systems several-fold.

54. The FCC has begun a series of proceedings to license additional wireless services. *In the Matter of Amendment of the Commission's Rules To Establish New Personal Communications Services*, 7 FCC Rcd 5676 (1992); *In the Matter of Amendment of the Commission's Rules To Establish New Personal Communications Services*, 7 FCC Rcd 7794 (1992).

55. The FCC has granted 203 experimental licenses for personal communications services ("PCS") as defined *in Notice of Proposed Rulemaking, Redevelopment of Spectrum to Encourage Innovation in the Use of New Telecommunications Technologies*, CC Dkt. No. 92-9 (FCC Feb. 7, 1992). Thirty five of these have been granted to cable companies.

56. Jones Lightwave Ltd. is an affiliate of Jones Intercable. Jones Lightwave Ltd. has FCC experimental licenses for PCS trials in Alexandria, Virginia, and in Illinois, Florida, and Colorado. *Experimental License Nos. 2429-EX-PL-92, 2430-EX-PL-92, 2431-EX-PL-92, 2432-EX-PL-92.*

57. The FCC has tentatively decided to grant a pioneer's preference in *In the Matter of Amendment of the Commission's Rules To Establish New Personal Communications Services*, 7 FCC Rcd 7794 (1992) to, among others, a cable company.

58. A good cause waiver application that was filed in April 1992 by the telephone company serving Bentleyville, Pennsylvania to provide video programming in that community, *Petition for Waiver and Section 214 Application, In the Matter of The Bentleyville Telephone Co.*, File No. W-P-C-6817 (Apr. 29, 1992), is pending. Helicon, the incumbent cable operator in Bentleyville, filed an opposition on June 11, 1992.

59. An April 1990 good cause waiver application, opposed by the NCTA, to provide video programming over fiber optics by the telephone company serving Ranchos Las Flores, California, *Public Notice: Contel of*

California, Inc. Section 214 Application and Request for Waiver of the Telco/Cable Cross-Ownership Rules, File No. W-P-C-6575 (Mar. 12, 1990), is pending.

60. In February, 1987, GTE California, Inc., the telephone company serving Cerritos, California, applied to the FCC for authority to construct cable facilities in Cerritos. That application was granted in July 1989. On the NCTA's petition for review, the D.C. Circuit remanded the matter to the Commission for further proceedings in September, 1990. *National Cable Television Ass'n, Inc. v. FCC,* 914 F.2d 285 (D.C. Cir. 1990). Thereupon, the FCC engaged in an effort to facilitate a voluntary settlement among the parties. When no settlement had been achieved by June, 1992, the Commission requested comments as to what further action it should take, and no order has issued.

61. Approximately 34 million people live in the states where Bell Atlantic's local exchange telephone companies provide telephone service.

62. Some cable companies charge additional fees for connecting additional television sets and for additional set-top converters that are sometimes needed to decode the cable signal.

63. Since 1978, to the best of the parties' current knowledge, C&P has never terminated an agreement for pole attachments or conduit with a company that was providing cable service to customers.

64. Since 1978, to the best of the parties' current knowledge, there has never been a complaint to the FCC regarding C&P's conduit rates.

65. High-bit-rate digital subscriber line technology (HDSL), which is a two-way version of the technology used for asymmetric digital subscriber line (ADSL), is used in commercial applications for data transmission.

66. Broadcasters and cable operators do not currently provide high-definition television.

67. BVS is assertedly still in the process of arranging to obtain from suppliers the video programming that BVS will provide directly to subscribers, and to obtain the right to retransmit such programming.

68. BVS is assertedly still in the process of developing the programming that it would seek to have originated on its behalf.

Stipulations Proffered by the Government Defendants [2]

69. As used herein, the terms "affiliate" and "affiliated" shall have the same meaning as in 47 U.S.C. §§ 522 (1), 533(b). Plaintiffs Chesapeake and Potomac Telephone Company of Virginia ("C&P") and Bell Atlantic Video Services Company ("BVS") are affiliated with each other and with a number of local wireline telephone exchange carriers by virtue of their common ownership by Bell Atlantic Corporation ("Bell Atlantic"). These affiliates provide local wireline telephone exchange service in the District of Columbia, Delaware, nearly all of Maryland, and portions of Virginia, West Virginia, Pennsylvania and New Jersey, as indicated below:

(a) The Chesapeake and Potomac Telephone Company provides local wireline telephone exchange and exchange access service in the District of Columbia.

(b) The Chesapeake and Potomac Telephone Company of Maryland provides local wireline telephone exchange and exchange access service in nearly all of Maryland.

(c) The Chesapeake and Potomac Telephone Company of Virginia provides local wireline telephone exchange and exchange access service in portions of

---

[2] Although the parties proffering each series of stipulations have been identified, the parties acknowledge that each stipulation herein was subject to negotiation and modification by all parties prior to agreement.

Virginia, including all of the City of Alexandria, Virginia ("Alexandria").

(d) The Chesapeake and Potomac Telephone Company of West Virginia provides local wireline telephone exchange and exchange access service in portions of West Virginia.

(e) The Diamond State Telephone Company provides local wireline telephone exchange and exchange access service in Delaware.

(f) New Jersey Bell Telephone Company provides local wireline telephone exchange and exchange access service in portions of New Jersey.

(g) The Bell Telephone Company of Pennsylvania provides local wireline telephone exchange and exchange access service in portions of Pennsylvania.

Other than Telecom Corporation of New Zealand, a Bell Atlantic affiliate that provides telephone service in New Zealand, no entity with which C&P, BVS or Bell Atlantic is affiliated provides local wireline telephone exchange service anywhere outside the above-described territory.

70. C&P currently provides, has sought authority to provide, or has announced plans to provide, channels of communication to the following unaffiliated entities, in the following places, for the purpose of providing video programming directly to subscribers:

(a) C&P provides channels of communication to Cablevision of Loudoun in the Cascades development in Loudoun County, Virginia, pursuant to, and subject to the conditions of, the FCC's *Order and Authorization*, File No. W-P-C-6649 (Jan. 11, 1991).

(b) C&P provides channels of communication to multiple unaffiliated video programmers in portions

of northern Virginia, pursuant to, and subject to the conditions of, the FCC's *Order and Authorization*, File No. W-P-C-6834 (Mar. 25, 1993).

71. C&P currently provides pole line attachments to 69 unaffiliated cable television operators in its territory, for the purpose of providing cable service directly to their subscribers.

72. C&P provides conduit to approximately 14 unaffiliated cable television operators in its telephone service area, for the purpose of providing cable service directly to subscribers.

73. Bell Atlantic's local telephone subsidiaries have provided, currently provide, have sought authority to provide, or have announced plans to provide, channels of communication to the following unaffiliated entities, in the following places:

(a) The Chesapeake and Potomac Telephone Company provides channels of communication in the District of Columbia to District Cablevision, Inc., for the purpose of providing cable service directly to subscribers.

(b) The Bell Telephone Company of Pennsylvania previously provided channels of communication in Perryopolis, Pennsylvania to the Helicon Group, Ltd. for the purpose of providing cable service directly to subscribers.

(c) New Jersey Bell Telephone Company has sought authority to provide video dialtone service in Florham Park Borough, Madison Borough and Chatham Borough, New Jersey to multiple unaffiliated video programmers, including Sammons Communications of New Jersey, Inc.

(d) New Jersey Bell Telephone Company has sought authority to provide video dialtone service in Dover Township, Ocean County, New Jersey to

multiple unaffiliated video programmers, including FurtureVision of America Corporation.

74. In November 1992, New Jersey Bell, a subsidiary of Bell Atlantic, entered into a 10-year agreement with FutureVision of America Corp. under which FutureVision agreed to use tariffed common carrier video transport service provided over New Jersey Bell's telephone network to provide video programming within New Jersey Bell's telephone service area.

75. On December 22, 1992, the New Jersey Board of Regulatory Commissioners announced its approval of a regulatory reform plan for New Jersey Bell, a subsidiary of Bell Atlantic, including endorsement of New Jersey Bell's plan to accelerate the deployment of broadband technology to every home and office in the state by 2010. Board approval for this investment was not required. During the proceedings before the Board in 1992, New Jersey Bell estimated that its total network capital investment through the end of the century would be approximately $5.3 billion.

76. There have been discussions between Bell Atlantic and one or more video programmers regarding the provision of video programming services outside the areas where Bell Atlantic's telephone companies provide telephone service.

77. As of 1992, the following Bell Atlantic local telephone subsidiaries provided pole line attachments to the following numbers of unaffiliated cable system operators in their telephone service areas:

(a) New Jersey Bell Telephone Company provides pole attachments to approximately 66 unaffiliated cable operators in New Jersey.

(b) The Chesapeake and Potomac Telephone Company provides pole attachments for video transport facilities that C&P holds legal title to, and that are

leased to an unaffiliated cable operator in the District of Columbia.

(c) The Chesapeake and Potomac Telephone Company of Maryland provides pole attachments to approximately 36 unaffiliated cable operators in Maryland.

(d) The Chesapeake and Potomac Telephone Company of West Virginia provides pole attachments to approximately 87 unaffiliated cable operators in West Virginia.

(e) The Diamond State Telephone Company provides pole attachments to approximately 7 unaffiliated cable operators in Delaware.

(f) The Bell Telephone Company of Pennsylvania provides pole attachments to approximately 148 unaffiliated cable operators in Pennsylvania.

78. As of 1992, the following Bell Atlantic local telephone subsidiaries provided conduit to the following number of unaffiliated cable system operators in their telephone service areas:

(a) New Jersey Bell Telephone Company provides conduit to approximately 34 unaffiliated cable operators in New Jersey.

(b) The Chesapeake and Potomac Telephone Company provides conduit for video transport facilities that C&P holds legal title to, and that are leased to an unaffiliated cable operator in the District of Columbia.

(c) The Chesapeake and Potomac Telephone Company of Maryland provides conduit to approximately 8 unaffiliated cable operators in Maryland.

(d) The Chesapeake and Potomac Telephone Company of West Virginia provides conduit to approximately 7 unaffiliated cable operators in West Virginia.

(e) The Diamond State Telephone Company provides conduit to two unaffiliated cable operators in Delaware.

(f) The Bell Telephone Company of Pennsylvania provides conduit to approximately 11 unaffiliated cable operators in Pennsylvania.

79. C&P represents that the provisions contained in the License Agreement For Pole Attachments And/Or Conduit Occupancy dated September 1, 1992 between C&P and Century Mountain Corp. are typical of C&P's agreements with cable operators for lease of pole attachments and conduit space.

80. Pacific Telesis Corp. either directly or through entities with which it is affiliated (including its wholly owned subsidiary, Pacific Bell) provides local telephone service only in portions of Nevada and California. Pacific Telesis has an option to buy a majority interest in Prime Cable of Chicago, Inc., which provides cable service in Chicago, Illinois.

81. Southwestern Bell Corp. ("Southwestern"), either directly or through entities with which it is affiliated, provides local telephone service in Arkansas, Kansas, Missouri, Oklahoma and Texas. Southwestern has an agreement with Hauser Communications, Inc. to purchase and operate Montgomery County Cablevision (which provides cable service in Montgomery County, Maryland) and Arlington Cable Partners (which provides cable service in Arlington County, Virginia).

82. C-TEC owns Commonwealth Telephone Company and C-TEC Cable Systems. As of June 30, 1992, C-TEC Cable Systems provided cable service to subscribers through 76 cable systems in four states. C-TEC Cable Systems provides cable television service outside the areas where Commonwealth Telephone Company provides telephone service.

83. As of March 15, 1989, and prior to its sale, Centel Corp. held 82 percent of the stock of Centel Cable TV Co. As of 1989, Centel Cable TV Co. provided cable television service to subscribers through 132 cable systems in six states outside Centel Corp.'s telephone service area. In 1989, Centel exited the cable business by selling its cable systems.

84. According to a February 1993 US West press release, US West is taking "a major step toward building a new combined video and voice communications network" and has requested bids for the components of a "broadband telecommunications network capable of providing video, data and voice communication service." According to US West, the network will have "the ability to offer traditional telephone service—basic dial tone, caller ID, voice messaging, etc.—as well as the traditional services offered by cable TV companies." The first technical trials of this upgraded network will begin November/December 1993 and regular commercial use will begin in late 1994.

85. In January 1993, Pacific Telesis announced a five-year plan to spend more than $1 billion to replace all of its remaining analog switches in California with state-of-the-art digital switches.

86. In July 1992, Ameritech announced plans to triple the amount of fiber optic facilities in its subsidiary telephone company networks over the next three years, including plans of Michigan Bell to invest $2 billion during the next four years in the deployment of advanced facilities, including fiber optic cable.

87. If C&P now were to enhance its telephone network in Alexandria to render it capable of providing video programming directly to subscribers, it maintains that it would replace its existing copper loop with a fiber optic system using coaxial cable drops. C&P also maintains that at the time it actually would begin enhancement of its network, it would use the optimal technology avail-

able, which, other than fiber optics, might include asymmetric digital subscriber line ("ADSL") technology.

88. C&P estimates that the present cost of replacing its existing copper loop facilities in Alexandria with the fiber optic facilities necessary to provide video programming and other services to subscribers in Alexandria is $50-100 million.

89. ADSL technology, which was developed in approximately 1991, has never been used on a commercial basis to provide video programming directly to subscribers.

90. As far as the parties are aware, ADSL's capability to provide video programming directly to subscribers has never been tested under real-world conditions over a telephone network, prior to C&P's test being conducted in Northern Virginia pursuant to the FCC's *Order and Authorization,* File No. W-P-C-6834 (Mar. 25, 1993).

91. Currently, ADSL technology requires that an entire program be digitally coded and compressed before it can be made available for viewing by subscribers.

92. Digital compression and encoding equipment is used to prepare video programming for transmission over ADSL-equipped copper loops. Currently, C&P has no equipment capable of compressing and encoding video programming on a real-time basis. This means, for example, that using ADSL, C&P currently could not provide live sports or news programs to subscribers at the same time such programs would be available to viewers of broadcast or non-ADSL dependent cable television.

93. Currently, one telephone line using ADSL technology can deliver only one video signal into the home at a time. If more than one television set is hooked up to a single ADSL-equipped telephone line, all sets will be limited to showing the same program. Additional ADSL equipped telephone lines to the home are required in order to watch different programs on different sets at the same time. With conventional cable technology, a single coaxial cable carries multiple channels of programming

into the home; multiple television sets can show different programs.

94. ADSL technology is not currently capable of providing high-definition television.

95. C&P may or may not charge a fee to subscribers for installation of commercial ADSL service.

96. ADSL transmission technology, the specifications for which were developed by Bellcore, is available to Regional Bell Operating Companies other than Bell Atlantic.

97. If C&P's telephone network is enhanced as referred to in the Complaint, ¶ 28, plaintiffs assertedly plan to transmit digital voice, data and video signals over the network on an integrated basis. Thus, in addition to the local telephone exchange and exchange access service now already provided, plaintiffs assertedly would use the network, as enhanced, for the transmission to consumers of video programming provided by BVS, the video programming of unaffiliated program providers, and any non-video information services of C&P, BVS and other providers.

98. Coupled with these transmission services, plaintiffs assertedly would provide a means through which consumers would have access to the video and non-video providers on the network and choose the video programming (or other information services) they wish to use at any given time. Plaintiffs assertedly would offer these services to BVS, unaffiliated video programmers and other information service providers on a tariffed, non-discriminatory, basis.

99. Plaintiffs also assertedly plan to provide consumers access through the network to enhanced and non-common carrier services. Enhanced services, which could be offered either by plaintiffs or other service providers on the network, might offer consumers advanced program search and preview capabilities, and other functions.

100. If plaintiffs rely on technology other than, or in addition to, fiber optics (e.g., ADSL, encrypted broadcast transmission, local or multichannel multipoint distribution system, or direct broadcast satellite transmission), to provide video programming to subscribers, they may or may not provide it in the manner described in paragraphs 97-99, above.

101. C&P's telephone network currently has no capability of providing video programming directly to subscribers in its telephone service area without the enhancements referred to in Complaint, ¶ 28, with the exception of:

> (a) the service now being provided in the Cascades Development of Loudoun County, Virginia pursuant to, and subject to the conditions of, the FCC's *Order and Authorization*, File No. W-P-C-6649 (Jan. 11, 1991); and
>
> (b) the service now being provided in Northern Virginia pursuant to, and subject to the conditions of, the FCC's *Order and Authorization*, File No. W-P-C-6834 (Mar. 25, 1993).

102. As of this time, plaintiffs have neither received nor applied for, nor prepared an application for, authority from the FCC, pursuant to section 214 of the Communications Act of 1934, to make the enhancements (as referred to in the Complaint, ¶ 28) that are necessary to render C&P's telephone network capable of delivering video programming directly to subscribers on a commercial basis, except as noted in paragraph 101(a), above.

103. As of this time, plaintiffs have neither received nor applied for, nor prepared an application for, authorization from the FCC to provide video programming directly to subscribers in Alexandria via (i) encrypted broadcast transmission, (ii) local multipoint distribution systems, (iii) multichannel multipoint distribution systems, or (iv) direct broadcast satellite. Plaintiffs have

no agreements with operators of such systems to lease excess spectrum capacity that could be used to provide video programming to subscribers in C&P's telephone service area.

104. C&P, BVS and Bell Atlantic do not, either individually or collectively, hold or have a pending application or bid for a local cable television franchise in Alexandria, Virginia or elsewhere in C&P's telephone service area.

105. Bell Atlantic is seeking, on behalf of itself and its local telephone subsidiaries (such as C&P), a waiver of the terms of the consent decree in *United States v. Western Elec. Co.*, No. 82-0192 (HHG) (D.D.C.) (also known as the "Modification of Final Judgment," or "MFJ") so as to permit Bell Atlantic and its subsidiaries to transport video programming without regard to local access and transport area ("LATA") boundaries.

106. The Washington, D.C. Metropolitan LATA, in which Alexandria is located, encompasses the District of Columbia and portions of Virginia and Maryland.

107. As of this time, plaintiffs have not entered into any written contracts to take delivery within the Washington, D.C. Metropolitan LATA of programming to be provided directly to subscribers that originates outside the Washington, D.C. Metropolitan LATA and that would have to be delivered by satellite.

108. Examples of video programming that would originate inside the D.C. Metropolitan LATA include:

—programming stored within the LATA

—local broadcast programming

—local origination programming

—local public, educational or governmental programming

109. Examples of programming that would originate outside the D.C. Metropolitan LATA include:

—distant broadcast signals such as WWOR or TBS;

—satellite cable programming such as ESPN or CNN, and pay cable channels such as Home Box Office or Cinemax.

110. Currently, BVS is the only video programmer that has committed to use the video transport services to be offered commercially over C&P's telephone network in Alexandria. No other programmer has contracted or otherwise committed to use C&P's network in Alexandria.

111. C&P and BVS have not entered into any written contract for the provision of video transport services by C&P to BVS. As of this time, C&P has not prepared the schedule of tariffs under which it would provide video transport services to BVS or others.

112. BVS currently owns no video programming.

113. BVS can obtain video programming for distribution on C&P's network, or elsewhere, only by (i) acquiring, or acquiring the right to restransmit, programming owned or controlled by others, (ii) by contracting with persons capable of originating video programming on BVS' behalf, or (iii) producing original video programming on its own.

114. As of this time, no supplier of video programming has entered into a written contract to provide to BVS the video programming that BVS will provide directly to subscribers or to grant BVS the right to retransmit such programming.

115. As of this time, no one capable of producing original video programming on BVS' behalf has entered into a written contract to do so.

116. As of this time, BVS itself has not produced any video programming that it intends to provide to subscribers.

117. It is possible that plaintiffs might have a cognizable ownership interest in programmers, other than BVS,

who would provide video programming to subscribers in Alexandria over C&P's network.

118. C&P would not exercise direct or indirect editorial control over, or in any way participate in the selection or packaging of, the video programming planned to be provided over its network, with the exception of:

(a) video programming supplied by BVS, over which BVS will exercise editorial control, and which BVS will select and package;

(b) possibly, video programming provided by video programmers in which C&P, BVS or Bell Atlantic might have an ownership interest;

(c) introductory menus, gateways or other such information content that C&P, BVS or Bell Atlantic might provide;

(d) the possible exclusion of pornography or other offensive material to the extent permitted under common carrier regulation.

119. For the trial service being provided in Northern Virginia (*see* paragraph 101(b), above), C&P is using a video storage computer with a capacity to hold 30 feature-length films. At this time neither plaintiffs nor Bell Atlantic have acquired the larger video storage computer that they intend to use to provide video programming on a commercial basis.

120. If C&P's telephone network were used to provide video programming from BVS directly to subscribers, BVS' programming would be transmitted to C&P's network, and from there as far as the customer premises, via equipment and facilities to be owned by C&P. At this time, C&P has not obtained all the facilities and equipment that will be used as part of the enhancements referred to in the Complaint, ¶ 28.

121. BVS was incorporated on September 24, 1992.

122. C&P assertedly made its firm decision to pursue

the possibility of providing video programming directly to subscribers in C&P's telephone service area on September 14, 1992.

123. Until the July 25, 1991 decision in *United States v. Western Elec. Co.*, 767 F. Supp. 308 (D.D.C. 1991), and the October 7, 1991 decision of the D.C. Circuit to lift the district court's stay of its July 25 order, the MFJ, §§ II(D)(1), IV(J), prevented the Regional Bell Operating Companies (such as Bell Atlantic) and their subsidiaries from providing "information services," which included, *inter alia*, making available information (such as video programming) that may be conveyed via telecommunications. *See United States v. Western Elec. Co.*, 552 F. Supp. 131, 227, 229 (D.D.C. 1982).

124. For purposes of summary judgment plaintiffs make no claim, and agree that nothing in the record on summary judgment shall be admissible for purposes of proving, that their business activities, other than the activities they maintain they would engage in but for 47 U.S.C. § 533(b), have suffered any adverse economic impact attributable to section 533(b).

125. For purposes of summary judgment plaintiffs make no claim, and agree that nothing in the record on summary judgment shall be admissible for purposes of proving, that the value of their property has been affected by 47 U.S.C. § 533(b), except to the extent its value might be enhanced were they legally permitted, and otherwise profitably able, to engage in the activities prohibited by section 533(b).

126. BVS, which was incorporated on September 24, 1992, has no revenue or income.

127. C&P's annual gross revenue and net income for the years 1980-1992, as reported to the Securities and Exchange Commission, is as follows:

	Gross Revenue ($000)	Net Income ($000)
1980	998,928	133,683
1981	1,156,078	144,671
1982	1,293,394	169,257
1983	1,369,674	193,118
1984	1,260,152	184,837
1985	1,370,835	213,349
1986	1,451,086	204,041
1987	1,502,474	225,946
1988	1,544,988	232,167
1989	1,568,677	202,955
1990	1,654,598	230,312
1991	1,715,179	(8,336)
1992	1,748,717	258,601

128. The losses reported in 1991 are not attributable to 47 U.S.C. § 533(b). Changes in the rules of accounting for benefits (other than pensions) owed to retired former employees required that C&P take an after-tax charge against its 1991 income in the amount of $224,083,000.

129. Comcast's September, 1992 telephone call from Philadelphia to London used wireline interexchange service from AT&T.

130. In the aggregate, local exchange carriers, such as C&P, still provide the majority of interexchange access service.

131. AT&T is the largest long-distance telephone company. According to March, 1993 testimony of its Chairman before Congress, in 1992 AT&T "paid mostly the local telephone companies something on the order of $14 billion to connect with our customers and access costs. $19 million were spent accessing customers through alternate access suppliers. That is, 98.86 percent of our customer access was accessed through local exchange companies."

Respectfully submitted,

/s/ Wiley R. Wright, Jr.
WILEY R. WRIGHT, JR.
VSB #1006
HAZEL & THOMAS, P.C.
510 King Street, Suite 200
Alexandria, Virginia 22314
(703) 836-8400

Counsel for The Chesapeake and Potomac Telephone Company of Virginia and Bell Atlantic Video Services Company

STUART E. SCHIFFER
Acting Ass't Attorney General

RICHARD CULLEN
United States Attorney

RICHARD PARKER
Assistant U.S. Attorney

/s/ James J. Gilligan
THEODORE C. HIRT
JAMES J. GILLIGAN
SARAH L. WILSON
U.S. Department of Justice
Civil Division, Room 816
901 E Street, N.W.
Washington, D.C. 20004
(202) 514-3358

Counsel for Defendants United States of America, Federal Communications Commission, and Janet Reno, in her official capacity as Attorney General

DATED: April 30, 1993

UNITED STATES DISTRICT COURT FOR
THE EASTERN DISTRICT OF VIRGINIA
(Alexandria Division)

[Caption Omitted in Printing]

City of Charlottesville	]	
	]	ss.
State of Virginia	]	

AFFIDAVIT OF GLEN O. ROBINSON

Glen O. Robinson, being duly sworn, deposes and says:

1. I am the Albert Clark Tate Jr. Professor of Law at the University of Virginia in Charlottesville Virginia.[1]

2. I have been associated with the University of Virginia since 1976. I taught at the University of Minnesota Law School, 1967-74, practiced law with the firm of Covington & Burling in Washington between the years 1961 and 1967 (with two years leave to serve in the Armed Forces). I was educated at Harvard College (A.B. 1958) and Stanford Law School (LL.B. 1961).

3. My principal fields in teaching have been Administrative Law, Antitrust, Communications, Property and Torts. I have done scholarly work in all of these fields and practiced law in the first three of them. In Communications I have published on all facets of the subject. I served as a Commissioner of the Federal Communications Commission (FCC) from 1974-76. I have also served as U.S. Ambassador to the 1979 World Administrative Radio Conference—an activity of the U.N. re-

---

[1] A vita is attached.

sponsible for global radio frequency allocation and regulation—and as a consultant to the Department of State and the Committee on Telecommunications of the National Research Council, and to several private firms on communications issues.

I. Telephone Provision of Cable Service

4. It is important at the outset to stress that the issue here is not whether telephone companies (telcos)[2] should be permitted to offer cable service. The Cable Communications Policy Act of 1984, does not prohibit them from providing video programming service, *outside their home markets*, nor does it forbid offering channel service within home markets to *unaffiliated systems*.[3] Indeed, Southwestern Bell Corp. recently announced plans to buy and operate two large cable systems operating in the Washington metropolitan area.[4] In enacting restrictions on telco provision of cable service Congress adopted rules

---

[2] "Telcos" refers throughout to local exchange carriers—the Bell Operating Companies and the GTE operating companies.

[3] Section 533(b)(1) of the Act makes it unlawful for any telephone common carrier: "to provide video programming directly to subscribers in its telephone service area, either directly or indirectly . . . ." Section 533(b)(2) makes it unlawful for such a carrier: "to provide channels of communications or pole line conduit space, or other rental arrangements, to any entity which is directly or indirectly owned by, operated by, controlled by, or under common control with such common carrier, if such facilities or arrangements are to be used for, or in connection with, the provision of video programming . . . ." (Emphasis added.)

Throughout this affidavit I use the phrase "cable service" to refer indifferently to the provision of video programming service (covered by § 533(b)(1) of the Act or provision of channels or conduit space to affiliated systems (covered by § 533(b)(2) of the Act).

[4] "Southwestern Bell to Buy Arlington, Montgomery Cable," Washington Post, February 10, 1988, p.C1.

first promulgated by the FCC in 1970.[5] In doing so it did not seek to forbid telcos from exercising their "electronic speech" rights, but rather to constrain the telco's opportunity to use monopoly power in the exercise of those rights. To be sure, this constraint on telco provision of cable services has given cable systems a measure of protection against one source of competition. However, it is misleading to suggest that this was designed as a strategy of simple protectionism.[6] The aim was not the suppression of competition in the provision of cable television service. The concern underlying those rules and the later legislation was that telephone company provision of cable service in their home markets would permit telcos to discriminate against cable systems in the provision of facilities and permit them to gain an unfair competitive advantage by means of cross subsidizing their cable operations with revenues from the telephone operations.

II. Congressional Versus Administrative Judgment

5. Unsurprisingly, the wisdom of these restraints has been a subject of recurrent controversy. In recent times, as plaintiff has detailed in its memorandum supporting

---

[5] Certificate of Channel Facilities Furnished to Affiliated Community Antenna Television Systems, 21 F.C.C.2d 307 (1970), *aff'd sub nom.*, General Tel. Co. of Southwest v. United States, 449 F.2d 846 (5th Cir. 1971).

[6] *See* Affidavit of Thomas Hazlett, p.3, referring to the FCC's desire to "shelter" the infant cable industry from telephone competition. Considering the extraordinary regulatory constraints that were imposed on cable television at that time, it seems somewhat off the mark to describe the policy as one of protecting the cable industry. Be that as it may, the key point is that the policy did not preclude telco's from competing with cable, only from competing in home markets where there was the opportunity for strategic use of their monopoly power.

summary judgment,[7] the FCC has come to the view that the statutory restrictions on telco provision of cable service are no long necessary, and it has proposed that Congress the remove them.[8] The Department of Justice and the National Telecommunications and Information Administration (NTIA) are currently of the same mind. If this case involved judicial review of its rules, the FCC's views about regulatory policy would be entitled to some deference, of course.[9] It should go without saying, however, that the question before this court is not what the *FCC* reasonably thinks but what it is constitutionally acceptable for *Congress* to think, and Congress has chosen to think for itself, declining to repeal its earlier assessment of the need for restrictions on telco provision of cable services.[10]

6. To impose on Congress what the FCC, or the Department of Justice or NTIA, deems reasonable in regard to regulatory policy is always inappropriate given the different standards of judicial review that apply to

---

[7] Plaintiffs' Memorandum in Support of Their Motion for Summary Judgment, pp. 14-17.

[8] *See* Second Report and Order on Telephone Company-Cable Television Cross-Ownership Rules, 7 FCC Rcd 5781 (1992) (hereinafter "FCC Second Report on Cross Ownership").

[9] As an aside it is doubtful that the court would owe *any* deference to the views of the Department of Justice or the NTIA since neither agency has any regulatory responsibility in this matter.

[10] In 1992 Congress did revisit other aspects of the 1984 Act—*see* Cable Television Consumer Protection and Competition Act, 106 Stat. 1460 (1992)—but it did not alter the 1984 restrictions on telco provision of cable service, despite the FCC's recommendations, of which Congress was quite fully aware. The FCC's Second Report appeared just prior to enactment of the 1992 Act, but the recommendations had been tentatively endorsed by the FCC at earlier stages in the rulemaking dating back to the original Notice of Proposed Rulemaking, issued in 1988. *See* FCC Second Report on Cross Ownership, para. 119.

Congress on the one hand and agencies on the other.[11] In this instance, however, there is special reason not to conflate agency and congressional judgments given that those judgments involve different assessments of the capacity and competence of the *agency* to deal with the problem at hand. The FCC does not now assert that the risks of anticompetitive discrimination or subsidization by telco provision of cable service in home markets that were found to be serious concerns in 1970 and 1984 have wholly disappeared. Though it has asserted that the risks "have been attenuated" by the growth of the cable industry[12] the agency concedes that the risks are sufficient to impose significant restraints on the telcos.[13] The gap between Congress and the FCC on how to deal with the telco problem reduces to a different assessment of the reliability of FCC regulations. The FCC believes that its own discretionary programs are sufficient to avoid the risks of anticompetitive conduct. Self-assessments are not inherently wrong, of course, but the bias on which they rest is always ground for others—Congress, the public and the courts as appropriate—to take a skeptical hard look at the assessment. This counsel comes with particular force in light of the history of telco regulation, a history of FCC frustration in controlling telephone company practices.

III. Reliability of FCC Regulation

7. Such has been the pace of change in the decade since the breakup of the Bell System in 1982 it is easy to forget that a central premise for the Department of

---

[11] *See, e.g.*, Motor Vehicle M'frs. Ass'n v. State Farm Mutual Automobile Ins. Co., 463 U.S. 29, 43 n.9 (1983) (rejecting government's argument that agency rulemaking ought to be accorded same deferential respect accorded to Congress).

[12] FCC Second Report on Cross Ownership, para. 137.

[13] *Id.* at paras. 141-43.

Justice antitrust suit and resulting divestiture was the perceived inadequacy of FCC regulation to deal with the Bell monopoly.[14] The heart of that monopoly was the local exchange network.[15] The Modified Final Judgment (MFJ) dealt with that problem in two basic ways: first, it separated the local exchange service from nonlocal (interLATA) telephone services; second, it prohibited the local exchange companies—the Bell Operating Companies (BOCs) from providing competitive information services within the local markets where they had monop-

---

[14] *See, e.g.*, comments of Judge Harold Greene in BARRY G. COLE, ED., AFTER THE BREAKUP: ASSESSING THE NEW POST-AT&T DIVESTITURE ERA 45 (COLUMBIA U. PRESS, 1991), P. 45: "It was the ineffectiveness of the FCC in coping with the problem of anticompetitive activity in the telecommunications industry that led to the antitrust suit and hence the decree in the first place." Judge Greene is harsher in his judgments about the FCC performance than I am inclined to be, but we agree generally that the regulatory track record (of both FCC and state regulatory authorities) in controlling anticompetitive conduct by dominant telecommunications firms has been, at best, uneven.

[15] As Judge Greene recently explained in United States v. Western Elec. Co., 767 F. Supp. 308, 314-15 (D.D.C. 1991), pet. for review pending.:

> "[I]n the instance of the Regional Companies [Bell Operating Companies], their market power stems from . . . their still almost complete domination over the "last mile" of the telephone network, i.e., their monopoly of the local wires and switches without which few, if any, competitors can reach the ultimate consumers of telephone-based information services. In fact, around ninety-nine percent of the traffic to the ultimate subscriber must still pass, in the end, through the Regional Companies' local loops. This basic circumstance gives these companies the ability to exercise market power with respect to the information services markets, that is, to raise price, to restrict output, or both. The Regional Companies would be able to raise price by increasing their competitors' costs, and they could raise such costs by virtue of the dependence of their rivals' information services on local network access."

olies. The latter restriction has been removed by the District Court for the District of Columbia (Judge Harold Greene), which has continuing jurisdiction over the MFJ.* The court's action, now pending appeal, was taken with reluctance and reservation. However, the court felt that it was bound by an unusually stringent burden of proof imposed by the court of appeals, a burden that required it to defer to the Department of Justice (which supported removal of the restrictions) unless it could be shown that the restrictions were strictly necessary to protect the public interest.** Of course, in

---

* United States v. Western Elec. Co., 767 F. Supp. 308 (D.D.C. 1991), pet. for review pending. The district court's action came after an earlier refusal to remove the information services restriction from the MFJ was remanded by the court of appeals on the ground that the district court had applied the wrong burden of proof for judging whether the restriction was justified. 900 F.2d 283 (D.C.Cir.), cert. denied sub nom., MCI Communications Corp. v. United States, 111 S.Ct. 342 (1990). On remand the district court heard reargument on the information services restriction. Although the court remained convinced that the restriction should be retained, it believed that the burden of proof imposed by the court of appeals left no alternative but to order it removed.

** "In the opinion of this Court, informed by over twelve years of experience with violations in the telecommunications field, the most probable consequence of such entry by the Regional Companies into the sensitive information services market will be the elimination of competition from that market and the concentration of the sources of information of the American people in just a few dominant, collaborative conglomerates, with the captive local telephone monopolies as their base. Such a development would be inimical to the objective of a competitive market, the purposes of the antitrust laws, and the economic wellbeing of the American people. . . .

"For the reasons stated . . . when the Court tries to exercise its own judgment, it would conclude without hesitation that removal of the information services restriction is incompatible with the decree and the public interest. However, . . . the Court is not free to exercise its own judgment. Indeed, it has concluded that several rulings of the Court of Appeals in its 1990 opinion . . . leave

evaluating the information services restriction neither the district court nor the court of appeals was dealing with a congressional mandate, but only with a condition that had been incorporated into a consent settlement agreement between the Justice Department and AT&T, a settlement agreement in which the party on whose behalf the restrictions were imposed—the Justice Department—was actively pressing for their removal. Obviously, the present case is markedly different in respect to the character of the underlying mandate and the burden of proof issue. Whether or not Judge Greene was correct in believing that the information services restriction should be retained or correct in believing that he had no choice but to remove it, his careful opinion demonstrates the complexity of the underlying issues—which are, of course, the same issues that are implicated by the restriction on telco provision of cable service.

8. Central to Judge Greene's reluctance to remove the information services restriction from the MFJ was not simply the threat of anticompetitive conduct by the telcos but a persistent doubt about the adequacy of FCC regulatory controls to deal with it.[8] This is a claim the FCC has made before—often. My experience, like that of Judge Greene's (though from a different, and perhaps more sympathetic vantage point) causes me to be skeptical.

9. To begin with, assessing the FCC's claim for the efficacy of its regulatory strategies is extremely difficult without a stable point of reference. The FCC's recent proposal for dealing with telco provision of cable service is a case in point. In the event Congress accepts its proposed lifting of the restriction of telco provision of cable service, the Commission tentatively proposes to require telcos to provide video programming only through

---

8 (...decision [not to remove the restriction]. . . . It will accordingly be so, albeit with considerable reluctance.") 797 F. Supp. at 986-88.

[8] 797 F. Supp. at 988-89.

separate subsidiaries.[19] This is an arresting proposal given that its *Computer III* decision recently abandoned structural separation as a condition of telco provision of competitive services generally.[20] The Commission did not explain why it proposes to retain a regulatory requirement for telco-cable video programming that it has rejected for other services. Perhaps the subsidization problem in the former case is more serious than in the latter, or perhaps it is just a matter of the regulatory right hand not attending to what the left hand is doing. Whatever the reason for the FCC's apparent ambivalence, there is every likelihood that the rules promulgated today will be changed tomorrow. *Computer III* decision, which sets forth the pertinent federal rules governing the competitive relationship between the BOCs and competitive service providers like cable television systems, is still pending judicial review following an earlier remand from the Ninth Circuit. The court of appeals had previously found that the Commission's decision to substitute regulatory oversight for structural separation had not been adequately explained or justified. On remand the Commission largely adhered to its earlier decision relying on nonstructural regulatory controls. Whether or not the court accepts the Commission's second decision one can only speculate how long the present rules will remain in effect. The structural-separation rules that *Computer III* replaced lasted not much longer than the duration of the rulemaking proceedings required to design the replacement rules.

10. The question of stability to one side any assessment of the efficacy of the rules must note their formid-

---

[19] FCC Second Report on Cross Ownership, para. 141.

[20] Computer III Inquiry, 104 FCC 2d 958 (1986); 2 FCC Rcd 3035 (1987): 3 FCC Rcd 1135 (1988): 4 FCC Rcd 5927 (1989), *reversed and remanded sub nom.*, California v. FCC, 905 F.2d 1217 (9th Cir. 1990). Computer III Remand Proceeding, 6 FCC Rcd 7571, 7 FCC Rcd 909 (1992), pets. for review pending.

able complexity because the complexity of the rules is a fair indication of the complexity that the regulators see in the underlying problem. The complexity of the FCC's current regulatory scheme is also a guarantee that implementation and enforcement will not be easy. A scan of the FCC Record—almost any current volume will do—will reveal just how complex these rules can be. One might begin with a review of Commission rules explaining its Open Network Architecture (ONA) program and related rules, designed to provide conditions of nondiscriminatory access by competing service providers to telco facilities and basic services.[21] One could take the existence of these elaborate rules as evidence that the FCC is "on top of the problem," so to speak. However, that inference cannot be drawn without also drawing the inference that the problem is extraordinarily challenging—sufficiently so that reasonable minds (in and out of Congress) could question whether the FCC is equipped to deal with it. The slightest glance at the rules, and the Commission's seemingly endless outpouring of opinions explaining them,[22] will show that monitoring this mare's nest of complex regulations will require close regulatory attention.

---

[21] Under ONA, the BOCs are required to offer an unbundled set of ONA services to enhanced service providers based on expected market demand, the services' utility as perceived by enhanced service competitors, and technical and costing feasibility. The nondiscrimination safeguards consist of Customer Proprietary Networks Information (CPNI) rules, network information disclosure rules, and nondiscrimination reporting requirements. Network information disclosure rules ensure that independent service providers receive access to technical information related to new or modified network services affecting the interconnection of enhanced services to the BOC networks. *See* Filing and Review of Open Network Architecture Plans, 4 FCC Rcd 1 (1988); 5 FCC Rcd 3084 (1990); 5 FCC Rcd 3103 (1990); 6 FCC Rcd 7646 (1991), *pet. for review pending.*

[22] The Commission's ONA orders are chronicled in Computer III Remand Proceedings, 6 FCC Rcd. 7571 (1991).

11. My own experience as a participant in the Commission's efforts to wrestle with these problems in the mid-1970's was that regulation achieved only limited success in preventing AT&T from practices that handicapped access to its facilities, and not much more success in preventing cross-subsidization of its services. And that success, such as it was, was achieved only at a large cost, to the agency, to competitors and ultimately to the public. It is difficult to convey a sense of this frustration merely by referring to particular controversies over, say, access arrangements or competitive pricing disputes.[23] The problem was too pervasive to be captured by any single illustration. In part the problem was one of AT&T constantly seeking to test if not bend the limits of agency standards, the effect of which was to put the Commission under a constant burden of surveillance. The problem of coping with the sheer volume of information (much of it unreliable) and argument (much of it rhetoric) was exacerbated by a basic uncertainty as to how the standards should be implemented.[24]

---

[23] The major issues that come most immediately to my personal recollection are the interconnection disputes, that led up to the FCC's equipment registration program, see North Carolina Utilities Comm'n v. FCC, 552 F.2d 1036 (4th Cir.), *cert. denied*, 434 U.S. 874 (1977) (affirming FCC's registration program), the Execunet dispute; see MCI Telecommunications v. FCC, 561 F.2d 365 (D.C. Cir. 1977) (reversing FCC decision); and the disputes over competitive service tariffs, such as the Hi-Lo tariff, AT&T Co., 58 F.C.C.2d 362 (1976). Despite an abundance of rules and rulings these types of disputes were a continuous source of vexation to the Commission, and to the parties adversely affected by them, until *Computer II*.

[24] Again, my experience is broadly congruent with Judge Greene's observations: "Beyond the naturally still isolated examples of anticompetitive conduct discussed below, there is the overriding fact, which experience has validated again and again, that as a practical matter it appears to be impossible for regulators to devise simple rules to govern the many economic, technical, and financial circumstances affecting behavior in an area that is char-

12. The regulatory environment of the 1990's offers a replay of the 1970's. As in the 1970's there is, first, the task of ensuring that competitive service providers have nondiscriminatory access to basic network services and information controlled by the telcos, and, second, that of ensuring a "level playing field" for all information service providers by preventing cross-subsidization by the telcos of competitive information services. ONA purports to deal with the first task but, as the Ninth Circuit recently held, does nothing to prevent the second.[25]

13. The cross-subsidization problem was an important concern in 1970, and in 1984; it remains one today. My experience with the Commission's efforts to deal with the problem in the mid1970's leads me to challenge the FCC's claim to be able to police this problem with accounting rules[26] as a means of preventing cross-subsidization. The current cost allocation methodology is essentially the same (with greater liberalization in the definition of cost categories) as that adopted in 1976, when it first mandated fully distributed cost allocations.[27] Whether or not fully distributed cost methods are appropriate accounting conventions—as to which there is much dispute—

---

acterized by technological change perhaps more than by any other factor. Yet unless the rules are quite simple and straightforward, the Regional Companies will be able to contend, again and again, that any particular rule is not applicable to whatever anticompetitive practices they may be engaged in, and to tie up enforcement almost indefinitely in administrative proceedings and in litigation." 767 F. Supp. at 319-20.

[25] California v. FCC, 90 F.2d 1217, 1234 (9th Cir. 1990).

[26] Separation of Costs of Regulated Telephone Service from Costs of Nonregulated Activities, 2 FCC Rcd 1298, 6283 (1987); 3 FCC Rcd 6701 (1988), *aff'd sub nom.*, Southwestern Bell Corp. v. FCC, 896 F.2d 1378 (D.C. Cir. 1990).

[27] AT&T Co., 61 F.C.C.2d 587 (1976); 64 F.C.C.2d 959 (1977); 67 F.C.C.2d 1441 (1978), *aff'd sub nom.*, Aeronautical Radio Inc. v. FCC, 642 F.2d 1221 (D.C.Cir. 1980).

what is important in this context is that, even using the costing methodology most restrictive of manipulations promoting subsidization, the Commission did not eliminate the threat of cross-subsidization in the 1970's. At bottom the problem was one of implementation, involving detailed scrutiny of cost information supplied by AT&T. The Commission was not able to carry out this task effectively. It admitted as much by adopting the structural separations requirement in *Computer II*.[28]

14. The reasons why the Commission's detailed cost allocation system, developed after years of proceedings, failed to work in practice are not difficult to understand, and there is little reason to believe that today's circumstances differ in any significant manner. First, during the 1970's, the Bell System often failed to provide the cost data required by the Commission's rules and engaged in almost continuous litigation over what those regulations required. Second, determinations of the legality of AT&T's rates were hung up in administrative proceedings for years, with potentially harmful consequences to competitors and ratepayers.

15. The FCC's monitoring problem has not disappeared. If anything it has increased. Contrary to some popular wisdom, the agency's difficulties in monitoring

---

[28] In adopting its price-cap regime for AT&T the Commission claimed it would ameliorate the problem of cross subsidization by removing the incentive to engage in opportunistic cost shifting. Policy and Rules Concerning Rates for Dominant Carriers, 4 F.C.C. Rcd 2873, 2924 (1989). That claim was distinctly muted when it extended the price cap scheme to local exchange carriers. Second Report and Order on Policy and Rules Concerning Rates for Dominant Carriers, 5 F.C.C. Rcd 6786 (1990) (price caps for interstate services provided by Bell Operating Companies and the GTE Operating Company), *aff'd sub nom.*, National Rural Telecom Ass'n v. FCC, 988 F.2d 174 (D.C. Cir. 1993). The claim, which is open to dispute in any case, is largely irrelevant to the present case since the FCC's price cap scheme does not apply to most of the costs that are affected by the provision of local telecommunications services.

AT&T's responses to the emerging competition in the 1970's were only slightly a product of the latter's huge size, or the disparity in resources between the regulator and regulated. The main cause of regulatory burden was the number of different transactions that had to be monitored and the number of different players who were entering the market. Neither the transactions nor the players have diminished in number. The mere increase in the number of different regulated entities entails a nontrivial increase in regulatory burden. Overseeing one AT&T with seven regional divisions is not the same as overseeing seven independent firms, each with distinctive services, pricing policies and corporate goals. More important than the increased number of regulated entities, however, is the greater variety of active services, which in turn generates the need for new access arrangements between telcos and other independent service providers, which in turn generates more regulatory monitoring.

16. While the burden of the monitoring task has increased in the post-divestiture era, the FCC's ability to carry that burden has not. A 1987 General Accounting Office study of the FCC's plans and capabilities for controlling telco cross subsidies between competitive and regulated services concluded that the Commission did not have the requisite resources to deal with the problem. After noting that the elimination of structural separations safeguards (under the *Computer III* decision) put increased reliance on oversight methods, such as accounting audits, the GAO observed that the FCC's staff was inadequate to perform that oversight. Given agency staff levels and inspection schedules it was calculated that the major carriers or regional holding companies would be subject to audit "only once every 16 years." [29] The situa-

---

[29] GAO, TELEPHONE COMMUNICATIONS: CONTROLLING CROSS SUBSIDY BETWEEN REGULATED AND COMPETITIVE SERVICES (Oct. 1987), p. 53.

tion has not improved since the time of the 1987 report: in February of this year the GAO revisited the issue and found no acceleration in auditing schedules an actual decrease in available auditors.[30] It should not be assumed, incidentally, that the slack in agency auditing is made up by the audits performed by CPAs hired by the telcos. The 1993 GAO report indicates that on-site audits by FCC auditors discovered "cases of misallocations totalling over $300 million in which carriers charged expenses to the regulated side of the business and carriers' affiliates had overcharged regulated carriers for services and supplies." [31] If $300 million in misallocated costs are discovered by an auditing capability that can audit carriers "only once very 16 years," one can only imagine the magnitude of misallocations that would be discovered by an adequately staffed agency. This is not a small problem, and one must doubt that misallocations of this order of magnitude can be dismissed as mere bookkeeping error.

IV. Reliability of State Regulation

17. Even assuming a more effective FCC regulatory policy than has been witnessed in the past years, the problem of guaranteeing fair competition between the telcos and cable systems does not rest with the FCC alone, as the Ninth Circuit decision in *California v. FCC* [32] had occasion recently to remind the FCC when it overturned the agency's blanket preemption of state regulation of intrastate enhanced services. In fact the FCC is not even in charge of the larger part of the business that is of immediate concern to this case: only 30% of all local

---

[30] GAO, Telecommunications: FCC's Oversight Efforts to Control Cross-Subsidization (Feb. 1993), p. 4.

[31] *Id.* at 12.

[32] 905 F.2d 1217 (9th Cir. 1990).

exchange costs are regulated by the FCC; the rest is regulated by the states.[83]

18. The division of authority between the FCC and the state regulators has been hotly contested for many years, and it still has not produced clear and stable jurisdictional boundaries with respect to the terms and conditions of competitive access to basic telco services or the pricing of telco provision of enhanced services. Sorting out regulatory responsibility between state and federal regulators has been a vexing problem. In the most ideal conditions of harmonious cooperation between state and federal regulation defining regulatory boundaries is a difficult matter. As it happens, however, telecommunications regulation has not been characterized by such harmony. Throughout the 1970's the FCC fought a two-front war against AT&T on one front and state regulators on the other over the key issues of competition. In part the conflict between the FCC and state regulators was one of regulatory turf, but beneath the turf fight was a more basic clash over regulatory policy. The uneasy, and uncertain, relationship between federal and state regulators increases the uncertainty of regulation generally. In all events the unquestionably larger role that states now play in the telecommunications field means introduces new complexity to the question of how much reliance can be placed on regulatory oversight.

19. It is often remarked that state regulators have become more sophisticated and much better endowed with the necessary resources since the 1970's. I have no doubt this is true. If my recollection of state regulation during that period can be trusted, there was much room for improvement. But however much improvement there has been it does not alter the fact that regulatory policy across the nation is a highly variable, highly unreliable

---

[83] Policy and Rules Concerning Rates for Dominant Carriers, 4 FCC Rcd 2873, 2882 n.7 (1989) (First Report and Order, adopting price caps for AT&T).

product. A survey of state regulators conducted in October 1990 offers a glimpse of the problem. Of forty-five states responding to the survey only 11 had adopted or had actively under consideration regulations comparable to the FCC's ONA regulations; the number of states reporting the existence or pendency of cost accounting regulations to deal with cross subsidization was somewhat more encouraging with 23 states having regulations designed to prevent cross subsidization.[34] Of course, having programs to deal with the problem is meaningless unless the regulators have the resources to implement them. The resources are as variable as the programs: the 1990 survey found that staff assigned to telephone regulation ranged from one (Mississippi) to more than 250 (New York).[35] Most of the states fall closer to the low than to the high end of this range.

V. Regulation, Competition and Speech

20. It is not the purpose of this affidavit to discuss the application of First Amendment standards to economic regulation, but it is pertinent to take note of what should be obvious: that any judgment about the constitutionality of these regulations entails a close examination of the government purposes they are intended to serve, not simply their incidental effects.[36] Plaintiffs have

---

[34] Affidavit of Glen O. Robinson, October 1990, Attachment A, in United States v. Western Elec. Co., Civ. Action No. 82-0192.

[35] *Ibid.* In a number of states it respondents reported that agency staff are not assigned by utility. I assume that means that a staff member might do electric utility work one month and telco work another. Given the complexity of modern telecommunications issues nonspecialized work assignment cannot be explained on the assumption that utility regulation is interchangable, so it must be taken as a sign that the regulators are underfunded.

[36] *See, e.g.*, FTC v. Superior Court Trial Lawyers Ass'n, 493 U.S. 411, 428-30 (1990) (upholding antitrust ban on boycott organized for communicative purposes); FCC v. National Citizens Committee

argued that the present restrictions are not the least restrictive alternative, but such an argument presupposes a careful examination of the efficacy of alternative regulatory strategies and the capability of regulators to enforce them not facile generalizations about competition and free speech. The boundaries of a summary judgment motion are too confining for the kind of examination of regulatory strategy that lies at the core of the present controversy.

21. In this respect the *Sable Communications* case,[37] relied on by plaintiffs, is a misleading guide to what is involved here. In contrast to the indecency regulations in *Sable* the restrictions on telco provision of cable service are not designed to suppress a certain kind of speech content or message. The regulations here serve an independent economic regulatory purpose. While that independent regulatory purpose does not render the regulations immune from First Amendment scrutiny, it does call forward a more nuanced understanding of regulatory impact and regulatory alternatives than is properly applied to regulation directed at the message content of speech.

22. Of course, the regulations here do affect only the telcos' "speech." But this can hardly be a ground for special suspicion given that it was only the telcos that have posed the threat of anticompetitive conduct. One could imagine a similar threat emanating from other businesses, as the plaintiffs contend. But the fact that other threats can be imagined does not alter the fact that, based on historical experience, only the telcos have

---

for Broadcasting, 436 U.S. 775, 798-802 (1975) (upholding FCC ban on common ownership of newspaper and local broadcast stations); United States v. O'Brien, 391 U.S. 367, 376-77 (1968) (upholding criminal penalties for burning of draft card for symbolic purposes).

[37] Sable Communications, Inc. v. FCC, 492 U.S. 115 (1989).

been perceived to present a threat warranting regulatory concern.

23. The wisdom of the present restrictions on telco provision of cable service is a matter for serious debate, but the debate is only confused by forcing it into a debate about free speech. The real controversy here is about choosing among competing regulatory strategies for dealing with an economic problem that has existed, in largely unchanged form, for over twenty years. It is a controversy about the reasonableness of Congress' choice of economic regulatory strategies not about its choice of speech.

/s/ Glen O. Robinson
GLEN O. ROBINSON

[Notarization Omitted in Printing]

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF VIRGINIA

[Caption Omitted in Printing]

AFFIDAVIT

DISTRICT OF COLUMBIA, S.S.

Bruce M. Owen, being duly sworn, deposes and says:

1. I am the president of Economists Incorporated, a Washington DC economic consulting firm, and visiting professor of economics at Stanford University's Washington DC campus, where I teach courses on regulation and law and economics. I have published a number of books and articles dealing with telecommunications. From 1979-1981 I was Chief Economist at the Antitrust Division of the U.S. Department of Justice. Previously I was Chief Economist at the White House Office of Telecommunications Policy. I testified as an expert on behalf of the government in *United States v. Western Electric,* the antitrust lawsuit that led to the dissolution of the Bell System in 1984. A copy of my curriculum vitae appears as Appendix A to this affidavit.

2. I have been asked by the National Cable Television Association, Intervenors in this proceeding, to address the economic basis for the prohibition on local telephone companies' providing video programming in their telephone service areas in 47 U.S.C. § 533(b).

3. I believe that the restrictions on telephone company provisions of video services (practically, of cable

television service) were economically justified at the time of their adoption by the FCC in 1970, and remained justified when the restrictions were codified by Congress in 1984. Further, although the conditions justifying these restrictions are less compelling today than in 1984, the restrictions remain sound and will continue to be so for some time to come. My conclusions are based on, and limited to, the economic role of the restrictions in the context of United States competition policy.

4. Restraints on the competitive activities of firms are unusual and should be imposed only in abnormal and convincing cases. Such restrictions should have a sound conceptual basis and be supported by empirical evidence that they are necessary to preserve competition in particular circumstances. I believe such restrictions are appropriate in this case, however, to prevent likely anticompetitive behavior on the part of local telephone companies in cable television. This view is based not only on analysis of the ability and economic incentives of regulated local telephone companies to engage in anticompetitive behavior but also on the ample evidence that local telephone companies have actually engaged in monopolistic practices in the past.

5. I assume for purposes of my analysis that local telephone companies now have the ability to offer regulated common carrier facilities for the transmission of video programming provided by third parties. The restriction in § 533(b) applies to the business of packaging and marketing programming, not transmitting it. Thus, if it made economic sense for telephone companies to provide the underlying transmission facilities for cable television, they could do that now. Indeed, virtually all of the alleged competitive benefits from telephone company entry into video programming that Professor Hazlett discusses

in his affidavit would flow from video transmission competition by telephone companies currently permissible under § 533(b). That is, if telephone companies provided an alternative competing local transmission facility for video programming, competing program packagers and producers could readily enter the market using those facilities to provide video services to consumers. [If such facilities-based competition made economic sense, it should already be occurring and § 533(b) does nothing to prevent it. If new technology makes such competition feasible in the future, § 533(b) will not stand in the way.] Moreover, if telephone companies—because of their resources and technical know-how—are able to provide better services or prices than incumbent cable operators, nothing stops telephone companies from competing on equal terms with cable operators outside their telephone service areas.

6. Telephone companies may claim there is insufficient incentive for them to provide underlying video transmisison facilities without the ability also to offer video programming services. This is an extraordinarily dubious claim. For more than one hundred years, the business of telephone companies has been to provide common carrier telecommunications facilities for the use of others. Telephone companies do not originate the conversations that give rise to a demand for their transmission service. Just as with telephone conversations, there are no obvious economies of scope or of vertical integration arising from both laying fiber optic cable and producing or buying and then packaging video programming. Why should the cost of providing transmisison service be lower because the telephone company provides video programming? The case of cable television companies is distinguishable, because at the time cable

companies developed there was an insufficient supply of video programming for cable television. By integrating vertically, cable companies expanded the demand for their services. Today, there is a very substantial video programming industry already in existence and ready to supply service at competitive rates.

7. The danger in permitting telephone companies to provide video services in competition with other local sources of video programming involves sequential telephone company encroachment on two related activities. First, telephone companies are likely to exploit their ability to engage in cross-subsidization to eliminate competition in the local transmission of video services. Monopolization of underlying facilities to transmit video services will result in an *increase in the price of local telephone service.* Having eliminated competing means of access to viewers, telephone companies are then likely to displace more efficient providers of, and to tend to monopolize, the provision of video services as a further means to evade the regulatory constraint they face as facilities-based common carriers.

Competition Policy and Regulation

8. Competition has a pivotal role in our private market economy, and has long been a central goal of public policy. The Supreme Court has characterized our national policy of competition as follows:

> Antitrust laws in general, and the Sherman Act in particular, are the Magna Carta of free enterprise. They are as important to the preservation of economic freedom and our free enterprise system as the Bill of Rights is to the protection of our fundamental personal free-

doms. *United States v. Topco Associates,* 405 596 at 611 (1972).

9. Competition protects the interests of consumers in efficient prices, cost-effective production, and technological progress through its effects on the economic incentives facing sellers. Competition assures that sellers who serve consumer interests survive and prosper; those who do not fail and are replaced by others.

10. The process of competition sometimes fails, calling for public policy responses. Sellers, for example, may form cartels, or seek through merger to achieve monopolies. In addition, monopolists may attempt to exploit their market power in unacceptable ways, or to extend it to other markets. These threats to the process of competition are regulated through the antitrust laws. Many communications laws, in fact, including § 533(b), are simply industry-specific applications of the broader principles underlying the antitrust laws. In addition, the pricing and other decisions of certain monopolies are regulated directly by public utility commissions.

11. A familiar problem in competition policy is that of "leveraging," which occurs when a monopolist in one market seeks to leverage its market power into a second market. Such problems may arise, for example, in the case of tying. *See generally, Eastman Kodak Company v. Image Technical Services* 112 S.Ct. 2072 (1992). Leveraging is most likely to be a problem where circumstances prevent a monopolist from exploiting its economic power fully in the primary market; in such cases, encroachment upon a second market may enable the monopolist to extract additional profits from its primary market. Competition policy condemns this for two reasons. First, customers in the primary market are injured by being

required to pay more for the monopolist's goods. Second, the monopolist injures competition in the second market by displacing more efficient competitors, and perhaps even by monopolizing the second market. Thus, consumers are harmed in both markets.

12. It has been recognized for more than thirty years that one species of leveraging exists because classic public utility rate regulation creates incentives to engage in anticompetitive behavior.[1] Traditional public utility regulation requires a monopolist to price on the basis of the cost of providing service, to which is added a fair rate of return on invested capital. If the resulting price is less than the monopolist's profit-maximizing price, such regulation creates incentives for the utility to avoid, evade, or ease its regulatory constraint. In certain circumstances, this evasion can be achieved by invading a second market and displacing more efficient competitors in that market. Professor Kahn describes regulated monopolists'

> . . . tendency to reach out for additional business, inside or outside the sphere of their franchised public-utility operations, if need be at rates below incremental costs. . . . [T]his kind of behavior is most likely to be encountered in

---

[1] Averch and Johnson, *Behavior of the Firm Under Regulatory Constraint*, 52 Amer. Econ. Rev. 1052 (1962). For a fuller development of the theoretical issues raised by cost-of-service-regulated monopoly firms participating in competitive activities, *see* Brennan, *Why Regulated Firms Should Not Be Allowed in Unregulated Markets: Understanding the Divestiture in* U.S. v. AT&T, 32 Antitrust Bull. 741 (1987); Brennan, *Cross-Subsidization and Cost Misallocation by Regulated Monopolists*, Journal of Regulatory Economics (1990) 37, and Noll and Owen, *United States v. AT&T: The Economic Issues*, in J. Kwoka and L. White, eds., The Antitrust Revolution, (1989, rev. ed. 1993).

> competitive situations, because it is there that the elasticity of demand may require unremunerative rates if the regulated company is to obtain the business and in this manner to increase its rate base. A. Kahn, 2 The Economics of Regulation: Principles and Institutions 54 (1971) [footnote omitted].

13. Invasion of secondary markets helps a regulated monopolist evade regulatory constraint by creating opportunities to inflate the apparent costs of providing its primary monopoly service. If services in the second market are provided using common items of equipment or personnel, or if the services produced in the second market are used in the primary business, opportunities generally exist to engage in behavior that has the effect of increasing the apparent costs of providing the primary monopoly service. Professors Laffont and Tirole describe two such opportunities:

> A. *Accounting arbitrage.* The firm engages in accounting manipulations. Labor, raw material, and other inputs are imputed to any activity for which they are not used. The transfer prices for intermediate goods traded between divisions is set at the wrong level.
>
> B. *Allocative arbitrage.* The general office allocates its effort or attention to those activities that face the most powerful incentive schemes rather than to minimize total cost. To these activities are dedicated the best engineers or inputs. There is no imputation of expenses of one activity on another, but rather more attention is paid to certain activities. J.-J. Laffont and J. Tiorle, A Theory of Incentives in Procurement and Regulation 188 (1993).

14. Encroachment on the second market, because it generates additional monopoly profits in the first, may be profitable even when pricing below cost is required in order to make such inroads. This anti-competitive "cross-subsidization" may amount to indefinite predatory pricing in the competitive market. Such predatory pricing is profitable to the regulated firm from the outset. (In contrast, in traditional predatory pricing, the monopolist must eventually raise prices in order to recoup losses and enjoy the fruits of its predation. *Matsushita Elec. Indus. Co v. Zenith Radio Corp.* 475 U.S. 574 (1986) at 588-89.) Similarly, activities, even costly activities, that reduce the market share of rivals in the second market by increasing rivals' own costs, may be profitable. In either case the effect is an anticompetitive (i.e., injurious to consumers) partial or complete foreclosure of the market to competitors.

15. A second antitrust problem arises when there is a vertical relationship between the regulated monopoly and the unregulated or less strictly regulated competitive activity. Two entities are vertically related when one supplies a product that is used by the other as an input in production. Suppose a firm has a regulated monopoly in an "upstream" or input activity (for example, transmission facilities for video programming) that is essential for an unregulated downstream activity (for example, video programming services).[2] The vertical relationship affords

---

[2] In the context of video programming services, it is ambiguous which activity (programming or transmission) is an "input" because it depends on which entity is ultimately offering service to the public. If 533(b) were abolished and telephone companies offered integrated video programming over their own transmission facilities, programming would be an input, and therefore "upstream", of the final integrated service sold to consumers. Alternatively, transmission can be regarded as an input for a com-

such a firm opportunities to exercise increased market power in transmission and to realize the resulting higher profits in the unregulated activity. By discriminating against competing packagers of video services needing access to its monopoly transmission facility, the unregulated vertically-integrated video program supplier may be able to sell programming at inflated prices to retail customers. Further, in some circumstances the integrated monopolist can sell programming to itself at inflated prices in order to earn excessive profits.

16. The problems described above are quite general; they are not limited to telephone companies, or within telephony to the issue of cable television. For this reason, for example, the effects on horizontal competition to vertical acquisitions in regulated industries are a subject of special scrutiny under the Clayton Act. *See United States Department of Justice Merger Guidelines,* issued June 14, 1984 at § 4.23. (The 1984 *Guidelines* were superseded by the *Department of Justice and Federal Trade Commission Horizontal Merger Guidelines* issued April 2, 1992. However, according to a statement accompanying the 1992 *Guidelines,* various provisions of the 1984 Guidelines, including § 4.23, remain in effect.)

17. For example, the California Public Utilities Commission not long ago turned down a request by Southern California Edison to acquire a neighboring electric utility, San Diego Gas and Electric. The CPUC concluded that the proposed merger raised serious competitive problems because it would facili-

---

peting video packager that uses common carrier transmission facilities to deliver programs to the public. In this affidavit, I use the convention of describing programming as an upstream input because I am concerned with the dangers presented by a vertically integrated telephone monopolist.

tate evasion of regulation as contemplated by § 4.23 of the 1984 *Merger Guidelines. Southern California Edison and San Diego Gas and Electric*, California Public Utilities Commisison Decision 91-05-028, Application 88-12-035, (1991) at 79.

18. Similarly, the Department of Justice recognized that regulated electric utilities might engage in monopoly behavior with regard to markets for coal in order to evade regulatory constraint. *Competition in the Coal Industry: Report of the U.S. Department of Justice Pursuant to Section 8 of the Federal Coal Leasing Amendments Act of 1976 for Fiscal Year 1979* (1980) at 62ff.

19. Where problems such as those described in the examples above are found as isolated instances, they are treated under the antitrust laws or regulatory statutes on a case-by-case basis. Where they are pervasive and predictable consequences of regulation and industry structure, they are best dealt with through prophylactic rules.

20. The case of local telephone utility provision of video programming services is a particular instance of the problem that I have been describing. In traditional antitrust leveraging analysis, incursions by telephone companies into cable television could be treated as simple extensions of monopoly based, for example, on the market power of telephone companies over "bottlenecks" such as essential inputs required to provide cable service; poles and conduit space are examples. Modern economic analysis emphasizes as the basis for this incursion the opportunity it creates for a telephone monopolist to evade regulatory constraint and thus to enjoy a greater fraction of the potential unregulated monopoly profits from the provision of telephone service. The incentive to engage

in anticompetitive conduct in a second market is not eliminated by regulation of that market. Differences, either in regulatory treatment, *e.g.*, allowed rate or return, or in the elasticities of demand in the two markets, are generally sufficient to make it profitable for a regulated telephone company to expand in order to evade regulation of its telephone profits. Thus, while control of essential facilities is an element of the raising-rivals'-costs branch of the theory, it is by no means a necessary element. Profitable cross-subsidization does not require that the regulated utility control essential facilities.

21. In the next section, I describe in more detail the conditions that give rise to concern for competition when local telephone companies are permitted to enter local markets for video programming.

Anticompetitive Incentives of Local Telephone Companies

22. The expansion of a cost-of-service regulated local telephone company into the provision of video programming services threatens competition because such a combination is likely to allow the telephone company to evade the constraint that regulators have placed on its exercise of market power. For example, by allocating costs for both regulated monopoly telephone services and video transmission service to the regulated telephone operations, the firm may obtain regulatory approval for an increase in prices for its telephone services. Telephone companies' use of common facilities to provide both telephone service and video transmission services distinguishes telephone companies from, for example, electric utilities with regard to the provision of video services. Electric utilities would not for the most part provide video services on the same facilities used to deliver electric power, and hence would have substantially less opportunity to engage in cross-subsidization.

23. A price increase due to cross-subsidization involves an exercise of market power. The firm realizes increased profits at the expense of consumers. While the increased profits actually come from the regulated activity, from an accounting point of view they appear to accrue to the competitive activity. Similarly, having wholly or partly foreclosed competitors for transmission of video programming through such cross-subsidization, the regulated telephone company can foreclose competing video programming suppliers from its facilities and earn even higher profits on its video offerings. The incentive to foreclose competition flows from the constraints regulators place on the profits from the underlying transmission monopoly.

24. As I have already noted, the exercise of additional market power in the regulated telephone market, that is, evasion of rate regulation, is not the only problem that arises from the expansion of regulated monopoly telephone firms into competitive activities. This cross-subsidization of the competitive activity can inflate artificially the regulated telephone company's market share in the competitive market and eliminate more efficient competitors there.

25. The foreclosure of efficient video transmission competitors through cross-subsidization is exacerbated to the extent that local telephone companies also control bottleneck facilities. It is plaintiffs' contention that cable television systems are local monopolies. Hazlett Affidavit at ¶¶ 4-16. Cross subsidization by a telephone company which forecloses competition from cable companies would give the telephone company a transmission monopoly. The telephone company that provided program services would have the ability and incentive to discriminate against its video programming packager competitors who as a result

of the transmission monopoly may need access to its facilities to reach consumers.

26. The early history of cable television involved telephone companies' attempts either to deny access to cable companies or to charge them exorbitant fees for use of telephone facilities. Actual anticompetitive behavior on the part of telephone companies against cable television companies in the 1960s provided a sensible basis for the FCC to prohibit telephone companies from providing cable television services in 1970. In addition, the Pole Attachment Act of 1978, 47 U.S.C. § 224, was a partial response to these problems and provided regulatory oversight of charges for use of telephone facilities by cable companies.

27. If discrimination such as that described succeeds in raising rivals' costs, that will increase prices for video programming services above competitive levels, permitting the regulated telephone company to earn above-competitive profits in video programming services. Attempts by regulators to control the prices and profits telephone companies might earn in video programming services do not eliminate the incentives on the part of vertically-integrated telephone companies to exclude more efficient providers of video programming services. Due both to likely differences in regulatory treatment and in the elasticities of demand for telephone services versus video programming services, telephone companies generally will find it profitable for foreclose efficient competitors. The net effect is to raise costs and prices in both markets.

28. Finally, telephone companies' incentives to exclude cable companies from the market and to monopolize video programming services are magnified because cable companies with sophisticated fiber networks pre-

sent a potential competitive threat to local monopoly telephone services. *See* Stipulations 43 and 45; Plaintiff's Memorandum at 12; Hazlett Affidavit at ¶ 37.

29. The extension of a regulated monopoly into other markets may be harmful to competition in a variety of circumstances. The particular conditions that give rise to this danger in the case of local telephone company provision of video services are:

Market Power: Telephone companies characteristically have market power in the provision of local telephone services so that, absent regulation, they would be able to increase profits by raising telephone prices above the competitive or regulated level.

Regulation: Local telephone companies characteristically are subject to cost-based regulation that constrains prices to be below the prices that would maximize profits and that these firms would charge in the absence of regulation. In other words, local telephone companies have unexercised market power as a result of regulation. As I indicate *infra*, newer forms of regulation such as price caps still leave telephone companies with the incentive and ability to evade regulatory constraints.

Common Facilities: Local telephone companies have a substantial opportunity to engage in cross-subsidization when, as here, both the competitive video transmission service and the monopoly service are provided on common facilities with common costs. Stipulations 87, 88, and 97; Hazlett Affidavit at ¶ 32. Common costs mean that cross-subsidization is virtually impossible to detect and eliminate. It is the existence of significant common costs which differentiates telephone companies from electric utilities.

Competitive Activity: Local telephone companies expanding into program packaging typically would

face existing and potential providers of video services such as cable, wireless cable (MMDS), video rental outlets and direct broadcast satellite (DBS) providers. Because they would face competition, their expansion would reduce the market shares of rivals, including ones that may have lower costs or superior products.

Imperfect Regulation: Local telephone companies can reasonably expect to be able to obtain approval for an increase in their regulated telephone prices based on the higher costs that result from cross-subsidizing video transmission activities. In other words, regulatory agencies are not able to monitor the regulated telephone services and video services perfectly.

Vertical Relationship: Local telephone companies also have a substantial opportunity to engage in cross-subsidization when, as here, the competitive activity (program packaging) will be selling to the regulated entity. This "self-dealing" situation invites overcharging for input services in order to increase the apparent costs and therefore the permitted price of the regulated service. Moreover, in order to minimize the effectiveness of regulators in monitoring such transfer pricing, the telephone company will have incentives to deny the programming to competing distributors.

History of Anticompetitive Behavior by Telephone Companies

30. Concern on the part of the FCC and the Congress with the anticompetitive potential in telephone company provision of video services did not arise in a vacuum. The 1960s and 1970s were a period of great turmoil in telecommunications policy—one in which the federal government was promoting with

increasing urgency a role for competition. The long-standing telephone monopoly was falling into disfavor. The government was acutely aware that the Bell System opposed this policy. The local telephone companies owned then by AT&T engaged in exactly the practices described above in various nascent competitive markets for equipment and service, including anticompetitive activities against cable television companies. *See United States v. Western Electric*, Plaintiff's First Statement of Contentions and Proof 202, 239 (November 1, 1979). One result was the antitrust action that culminated in the dissolution of the Bell System. The Bell System was dissolved, amid prophylactic restrictions on the ability of local telephone companies to enter competitive markets, in 1984, the very year that § 533(b) was codified.

31. Thus, Congress had ample evidence that telephone companies respond to the incentives they face and engage in anticompetitive behavior. In *United States v. Western Electric*, the government's antitrust suit charged that, through inflated prices between vertical affiliates, cross-subsidization, and discrimination against rivals, the Bell System had violated the antitrust laws by (i) charging anticompetitive service and equipment prices to the customers of its regulated local telephone services, and (ii) using its status as a regulated monopoly in local telephone service to foreclose competition in and monopolize the potentially competitive long-distance telephone service and telephone equipment markets. The government called as witnesses several former Federal Communications Commission officials who testified to the ineffectiveness of regulation in preventing such abuses. The government's view was that regulators could not regulate the Bell System adequately. The Justice Department stated at the time that:

> At the heart of the government's case in *United States v. AT&T* was the failure of regulation to safeguard competition in the face of the powerful incentives and abilities of a firm engaged in the provision of both regulated monopoly and competitive services. Neither of these problems [cross-subsidization and discrimination] has thus far proven amenable to successful regulatory solution. Indeed, the very basis for divestiture is that the anticompetitive problems inherent in the joint provision of regulated monopoly and competitive services are otherwise insoluble. U.S. Department of Justice, *Response to Public Comments on the Proposed Modification of Final Judgment*, 47 Fed. Reg. 23, 320-336, May 27, 1982, quoted in *United States v. Western Elec. Co., Inc.*, 673 F. Supp. 525, 568, DDC 1987.

32. Opinions by the U.S. District Court for the District of Columbia on related issues, such as attempts to remove line of business restrictions agreed to by the Regional Bell operating companies in the consent decree in *United States v. Western Electric*, have upheld repeatedly the validity and applicability to present circumstances of the economic theory I have articulated, and that was relied upon by the Department of Justice. According to the Court, regulators were indeed unable effectively to monitor the behavior of telephone companies: [8]

> . . . . [T]he Court concluded following the close of the Department's case, and in accordance with the arguments presented by the Department, that "the Commission is not and never has been capable of effective enforcement of the

[8] The quotations below are from *United States v. Western Electric*, 673 F. Supp. 525 (DDC 1987), footnotes omitted.

> laws governing AT&T's behavior," and that accordingly AT&T had been able to violate the antitrust laws in a number of ways over a long period of time with respect to interexchange (long distance) services and the procurement of equipment. . . . 673 F. Supp. 531.
>
> . . .
>
> [T]he FCC was unable to prevent or to remedy major anticompetitive abuses by the Bell System achieved through the activities of its local affiliates. . . . The Department of Justice argued, and at the trial it introduced voluminous expert testimony and other evidence in support of its argument, that the local exchanges are so complex and so technically dynamic, and that they comprehend so many and such complex joint and common costs, that regulation could not prevent anticompetitive activities. . . . 673 F. Supp. 567-68.

Further, the Court has noted that the telephone companies retained the local monopolies that permitted leveraging to other, competitive markets and which are critical to the economic basis for restricting telephone company participation in related markets:

> The Court found that, were the Regional Companies allowed to be present in the interexchange market while they also maintained monopoly control of the local telephone markets, they would be able to pursue precisely the same course as had the Bell System: (1) to discriminate in a variety of ways against their nonmonopoly competitors through judicious use of the local monopoly; and (2) to "subsidize their interexchange prices with profits earned from their monopoly services." 673 F. Supp. 542 . . . [T]heir monopoly bottlenecks are as solid and pervasive as they were when the decree was en-

> tered. It is equally clear that nothing has occurred to change the decree conclusion that those in control of the local bottlenecks have the incentive and ability to use their monopoly power anticompetitively in the interexchange market. . . . 673 F. Supp. 546.

Moreover, the Court found the telephone companies have the power to "raise rivals' costs," just as economic theory predicts:

> The manufacturing restriction was based in substantial part on evidence presented by the Department of Justice at the trial of this case indicating that the Bell System had improperly monopolized the market for telecommunications equipment, in that its local Operating Companies purchased such equipment primarily from Western Electric Company, the System's manufacturing affiliate, and "engaged in systematic efforts to disadvantage outside suppliers." 673 F. Supp. 552 . . . As testimony and other evidence demonstrated, the Operating Companies managed, by one stratagem or other, to purchase Western Electric's products, even when those products were more expensive or of lesser quality than alternative goods available from unaffiliated vendors. 673 F. Supp. 553 . . . The Bell System subsidized the prices of its equipment with the revenues from the Operating Companies' monopoly services. The effect of this practice, as with respect to cross-subsidization generally, was (1) to permit the Bell System to undercut other producers of equipment (which lacked such a subsidy), and (2) unfairly to burden the consumers with excessive rates for the monopoly services they were furnished by the Operating Companies. . . . 673 F. Supp. 553-54.

In sum, the Court affirmed both the conceptual and empirical validity of the very economic theory I have articulated in this affidavit, and confirmed that the conditions were present to justify a restriction on the freedom of regulated local telephone companies to enter competitive markets:

> [M]any of the current operations of the Regional Companies take place in unregulated markets. This complex mixture of regulated and unregulated activities provides these companies both with a powerful temptation and with ample opportunity to commit anticompetitive abuses in the competitive markets and to subsidize their competitive operations with profits earned in the monopoly markets. 673 F. Supp. 569.

33. The anticompetitive problems associated with telephone company participation in competitive markets did not end with the dissolution of the Bell System in 1984. Because the local telephone companies remained regulated monopolies, they continued to seek opportunities to earn greater profits by breaking out of their regulatory constraints. For example, an audit of BellSouth by a NARUC task force in 1985 found cross-subsidies of new, competitive businesses from regulated telephone activities. Special Accounting Task Force of the Southern Public Service Commissions, *Report on the BellSouth Corporation,* (May 16, 1985) at 11. These practices by BellSouth were found to have continued in 1990. A California Public Utilities Commission audit of Pacific Telesis in 1986 also found cross-subsidies of unregulated businesses. California Public Utilities Commission, *Audit Report on Pacific Telesis,* (July 11, 1986) at 15. A NYNEX purchasing subsidiary overcharged regulated phone operations $118 million between 1984 and 1988 and was fined $1.4 million by the FCC. FCC,

Review of Affiliate Transactions Between NYNEX's LECs and Materiel Enterprises, (1989). US West admitted in 1991 to favoring its competitive switching offerings in granting access to its local network and paid a $10 million fine. Memorandum of the United States in Support of Motion and Stipulation for Entry of an Enforcement Order, *United States v. Western Electric Co.*, Enforcement Order, February 15, 1991. The Georgia Public Service Commission determined that Southern Bell Telephone, a telephone company of BellSouth Corporation, used its monopoly control of the local exchange market to impede competition in the voice messaging services market by discriminatorily denying competitors access to the local exchange network, and that "substantial issues of predatory pricing and cross-subsidy [had] been raised" with regard to the pricing of the service. *Order of the Commission, In the Matter of the Commission's Investigation Into Southern Bell Telephone and Telegraph Company's Provision of MemoryCall Service*, Docket No. 4000-U, at 67-68 (June 4, 1991). In 1992, Southern Bell agreed to pay approximately $15.2 million to more than 900,000 customers to resolve a grand jury investigation into charges that Southern Bell, *inter alia*, had intentionaly overbilled customers through the fraudulent sale of optional telephone services. In accepting the settlement, the grand jury issued a report recommending "stricter controls on the cost allocation procedures . . . to prevent the unlawful subsidy of the unregulated side by the regulated side." Press Release, Department of Legal Affairs, Florida Office of Statewide Prosecution (Oct. 9, 1992). A 1992 audit commissioned by the Louisiana Public Service Commission identified "numerous instances where BellSouth affiliate transactions were structured to benefit the Company's nonregulated ac-

tivities." *Report to the Louisiana Public Service Commission, Ratemaking and Financial Audit of South Central Bell Telephone Company,* Docket No. U-17949, Subdocket A, at ix (Aug. 1992). Indeed, the anticompetitive activities of the divested Bell Regional companies led the District Court to conclude in 1987:

> The Regional Companies are of course limited in the breadth and scope of the anticompetitive activities in which they are able to engage inasmuch as the most effective vehicles for such activities are beyond their reach due to the existence of the core restrictions of the decree. What is startling, however, is given the relative paucity of the field available for such acts, in how many ways these companies appear nevertheless to have managed to discriminate and to cross-subisdize. *United States v. Western Electric,* 673 F. Supp. 525, 580, footnote omitted.

Continued Existence of Anticompetitive Threat

34. The conditions sufficient to create the significant potential for anticompetitive harm by the expansion of local telephone companies into competitive activities still exist today with respect to telephone company entry into video programming services. For example, despite the emergence of competition for some local telephone services, basic local telephone service retains substantial monopoly characteristics. Stipulation 131.

35. Moreover, the market power of local telephone companies remains constrained by cost-of-service regulation. It has been argued that new forms of incentive regulation have reduced or eliminated the incentive of local telephone companies to engage in anticompetitive cross-subsidization. This type of regulation typi-

cally imposes price caps on regulated services and allows carriers greater profits if they are able to reduce their costs. If price caps, fixed in real terms, were kept in place for a long time, this type of regulation would not permit prices to increase if telephone companies' costs increased. In theory, price-cap regulation applied in that way could reduce or eliminate the incentive to shift costs to regulated services because those higher costs would no longer be recovered in higher prices for monopoly service. *See* Braeutigam and Panzar, *Diversification Incentives Under "Price-Based" and "Cost-Based" Regulation*, 20 RAND Journal of Economics 373 (1989).

36. In practice, however, telephone price-cap regulation does not ignore the profits and costs of the regulated firm. Telephone price caps typically are set, and periodically reset, on the basis of historical accounting costs. (In contrast, the price caps recently established by the FCC to govern cable television service rates are based not on historical costs but on comparisons with the rates charged by cable systems that face "effective competition". *Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation*, Report and Order, Docket MM-92-266- (released May 3, 1993), —FCC Rcd—(1993). Moreover, if profits are high, regulators will be under political pressure to reduce allowed prices. Conversely, low profits will bring pressure on regulators to allow higher prices. In other words, accounting costs and profits are likely in the real world to affect the price caps, and telephone companies are likely to take that into account in setting their course of conduct. But once regulatory constraints on prices are again tied to costs, they can be affected and, therefore, partially evaded by telephone companies' behavior. The regulated telephone

companies will retain the incentive to shift costs to regulated monopoly services and away from competitive activities. *See* Braeutigam and Panzar at 389. Further, these eventualities are reasonably foreseeable and thus likely to affect behavior in the present.

37. I conclude that under current conditions the prohibition on telephone company provision of cable television services remains necessary to prevent the likely monopolization of those services by local telephone companies. If the prohibition were removed, I believe it is likely that local telephone companies will use their regulated telephone revenues to cross-subsidize video programming transmission services and use their resulting control of essential facilities to discriminate against their video programming competitors. My conclusions about the risks today from telephone company provision of cable television services are echoed by the District Court's warnings in 1987 about telephone company expansion into related fields:

> The Regional Companies are now requesting entry into far broader competitive fields of endeavor than any in which they were permitted to function during the last three years. Based upon their performance during that three-year period, it would not be unreasonable to assume that cross-subsidization would also take place with respect to these new markets, and that it would occur on a far wider and more destructive scale than heretofore. That is so if only because cross-subsidies are much more easily concealed where—as between local exchange service and interexchange, telecommunications manufacturing, and information services—there are many common costs that can be attributed, almost at the companies' unfettered choice, to any of the

> various activities, than where cross-subsidization is attempted between exchange service and ventures foreign to telecommunications. *United States v. Western Electric*, 673 F. Supp. 525, 582-83.

The Court in 1991 once again affirmed the economic theory and the necessary underlying conditions for restricting telephone company expansion into competitive areas:

> In the opinion of the Court, informed by over twelve years of experience with evidence in the telecommunications field, the most probable consequences of such entry by the Regional Companies into the sensitive information services market will be the elimination of competition from that market and the concentration of the sources of information of the American people in just a few dominant, collaborative conglomerates, with the captive local telephone monopolies as their base. Such a development would be inimical to the objective of a competitive market, the purpose of the antitrust laws, and the economic well-being of the American people. *United States v. Western Elec. Co., Inc.*, 767 F. Supp. 308, 326 (DDC 1991).

Less Restrictive Alternatives

38. Because restrictions on the ability of any firm to enter new markets should be avoided whenever possible under the very principles that competition policy seeks to achieve, it is useful to consider whether there is some less restrictive alternative to the ban on telephone-cable cross-ownership that achieves similar protection for competition. For the reasons given below, I believe that there is not.

39. There are two candidates for the role of less restrictive alternative. First, either the antitrust authorities or regulators can deal with problems of cross-subsidy, discrimination and the like on a case-by-case basis, seeking to impose appropriate sanctions when such behavior is discovered. For the very reasons given above, however, this approach is likely to be extremely ineffective. Regulated utilities in general and telephone companies in particular have an enormous advantage over regulators, an advantage attributable to their control over information about costs and technologies. Judge Greene found that regulators in fact were unable to control AT&T's anti-competitive behavior. Moreover, as indicated above, the Bell Regional operating companies have continued since divestiture to engage in cross-subsidies and other anticompetitive behavior despite regulatory and antitrust oversight, and in spite of the fact that their incursions into related competitive activities have been severely curtailed by the Consent Decree in *Western Electric*. It would not be reasonable or economical of judicial resources, nor would it likely be effective in preventing anticompetitive abuses, to require repeated case-by-case enforcement of antitrust laws against so pervasive and likely a pattern of conduct.

40. Second, there are quasi-structural approaches such as that of the "fully separated subsidary". The idea here is to permit monopoly utilities to enter competitive businesses, while minimizing the regulator's difficulties in monitoring anti-competitive behavior by requiring that all the facilities, operations, personnel, books and records of the two activities be kept wholly separated. This approach might be successful in dealing with extensions to businesses that do not require the use of common facilities or vertical transactions with local telephone service, but it cannot work with respect to

telephone company provision of video programming services. Indeed, in two efforts to settle the antitrust case that led to the breakup of the old Bell System, the government and AT&T negotiated what became known as "Quagmire I" and "Quagmire II," in which attempts were made to specify all the behavioral and institutional safeguards that would be necessary to preserve competition if AT&T were to remain a combination of regulated local monopolies and competitive equipment and long distance businesses. These attempts failed because both parties realized that the concept was unworkable. B. G. Cole, ed., After the Breakup: Assessing the New Post-AT&T Divestiture Era, 8, 22, 37 (1991).

41. No amount of accounting separation combined with regulation and monitoring can deal effectively with the issue of common facilities and common costs that would exist if telephone companies provided video service in their own service areas. As indicated above, plaintiffs intend to offer competitive video transmission services and monopoly telephone services over common facilities. Plaintiffs do not plan to separate these transmission services from each other through separate subsidiaries nor could they. Therefore, separate subsidiaries offer no protection from anticompetitive cross-subsidization which would result in telephone company monopolization of video transmission services.

42. Another intractable problem with respect to cross subsidization by telephone companies of video programming services is improper allocation of the costs of financal risk-taking. As Professor Brennan has put it,

> Raising capital through borrowing may be a source of cross-subsidy. The regulator may

have a difficult time distinguishing whether the borrowing done was for the regulated product or another product. The regulated firm may be able to raise funds for ventures in other markets by borrowing against the assets of the regulated business. If the risk inherent in the regulated market is lower than that in the unregulated market, as might be expected given the residual unexploited demand created by regulation holding down price, this will result in subsidized lower-cost debt for the unregulated operations. The "subsidy" will be paid by increases in risk of the capital borrowed to pay for the regulated service, because that capital now bears some of the risk of the unregulated service. Brennan, *Why Regulated Firms Should Not Be Allowed in Unregulated Markets: Understanding the Divestiture in* U.S. V AT&T, 32 Antitrust Bull. 741, 763 (1987).

43. Nor would separate subsidiaries deal satisfactorily with discrimination issues. Having monopolized video transmission services, a telephone company would still have incentives to favor its video packager "subsidiary" in granting access to its monopoly transmission networks. The history of competitive abuses by AT&T involved exactly the same issues of discrimination in favor of AT&T's "separate" subsidiaries, Long Lines (AT&T's interexchange subsidiary) and Western Electric (AT&T's manufacturing subsidiary). Despite regulatory attempts to curtail these anticompetitive abuses, only divestiture and isolation of the monopoly local telephone companies from these related competitive activities was sufficent to eliminate them.

44. Finally, separate subsidiaries could not protect against "self-dealing" that could artificially raise video pro-

gramming costs. One strategy available to an integrated telephone company providing video programming services is to produce or have produced for it programming that it does not sell to other distributors. This was one strategy AT&T employed with Western Electric in selling exclusively to its affiliated local telephone companies equipment at inflated prices. Indeed, Plaintiffs are contemplating such exclusive programming for their Alexandria system. Horner Affidavit at ¶ 5. With no market transactions available to test the reasonableness of the prices charged for that programming, separate subsidiaries offer no protection from the evasion of regulation through the payment of excessive prices to unregulated program production affiliates.

Cable Monopolies

45. The Plaintiffs in this matter assert with vigor that cable television companies are monopolists, and that the national policy in favor of competition would be advanced by permitting the entry of telephone companies. Hazlett Affidavit at ¶¶ 30-31. There is no doubt that cable television companies have market power. But so do many firms in the economy; market power is a matter of degree. *Schurz Communications, Inc. v. F.C.C.*, 982 F.2d 1043 (7th Cir. 1992) at 1052.

46. Plaintiffs' argument is wrong-headed even if cable systems are monopolists. Competition is indeed promoted when barriers to entry are reduced. But competition is not promoted when regulated monopolists are permitted to leverage their economic power from one market to another, regardless of the structure of the secondary market. A I have noted above, such leveraging in the end generally harms consumers in *both* markets. The wisdom of excluding tele-

phone companies from the video programming business must be assessed independently of whether cable television companies are presently in possession of market power. In any event, actual and potential technologies such as direct broadcast satellites and wireless cable present far more immediate and legitimate competitive threats to the cable industry than telephone technologies. The special threat of telephone entrants is the ability, not necessarily to provide a superior service, but to engage in profitable long-term predation and discrimination, regardless of the quality of their service.

Future Considerations

47. In the future, conditions may change sufficiently to warrant removal of the prohibition of telephone company ownership of cable television systems. The market for local telephone service is beginning to face emerging competition for some business customers because of bypass, cellular, fiber optic ring, and other new technologies. DBS or other new developments may make it impossible for local telephone companies to monopolize transmission. It is important that the restriction on telephone provision of video services be kept in place, however, to ensure that the trend toward greater competition for local telephone services is not reversed. Significantly, the nascent competition that faces telephone companies is concentrated in their services to business customers. Cable probably is the only serious source of potential competition for residential telephone service; as I have noted above, the reverse is not true. It would be unwise economically to risk eliminating that potential threat by exposing cable television competitors today to anticompetitive behavior by local telephone companies. In the future, when it is possible to conclude with a reasonable degree of

confidence that the trend toward competition for local telephone services cannot be reversed by anti-competitive behavior on the part of local telephone companies, removal of the prohibition would be appropriate.

/s/ Bruce M. Owen
BRUCE M. OWEN

[Notarization Omitted in Printing]

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF VIRGINIA
(Alexandria Virginia)

[Caption Omitted in Printing]

REPLY AFFIDAVIT OF ALFRED E. KAHN

STATE OF NEW YORK

COUNTY OF TOMPKINS

(1) My name is Alfred E. Kahn. I am Robert Julius Thorne Professor of Political Economy, Emeritus, at Cornell University and Special Consultant to National Economic Research Associates, Inc. My business address is 308 North Cayuga Street, Ithaca, New York 14850.

(2) Among the experiences of mine pertinent to my submission in this proceeding are that I was Chairman of the New York State Public Service Commission between 1974 and 1977 and of the Civil Aeronautics Board in 1977-78; I am the author of the two-volume *The Economics of Regulation*, published originally by John Wiley & Sons in 1970 and 1971 and reprinted in 1988 by The MIT Press; I have written and testified extensively on the subject of telecommunications regulatory policy and published a book and numerous articles on antitrust policy. I was a member of the Attorney General's National Committee to Study the Antitrust Laws and the National Commission for the Review of Antitrust Laws and Procedures. I have been advisor on telecommunications policy to Governor Carey, of New York State, recently completed service as a member of the Ohio Blue Ribbon Panel on Telecommunications Regulatory Reform, and am at present a member of the New York State Tele-

communications Exchange. I attach a copy of my full resumé as an Appendix to this affidavit.

(3) The purpose of my affidavit is to appraise and respond to the government's proffered justification for the ban against the plaintiffs providing their video programming to the public within their telephone service areas—namely, that the prohibition is necessary to prevent the telephone companies from "cross-subsidizing" cable operations with revenues from their monopoly telephone operations. The result of such a cross-subsidy, the government contends, would be that the cable companies could or would be driven out of business, leaving the telephone company as the monopoly provider of both cable and telephone services.

(4) This contention of the government of the likely—or even possible—effects of a lifting of the ban rests on a number of key premises. The most important of these are that authorization of the telephone companies or their affiliates to create or assemble video programming for sale to the public, in addition to their present ability to carry the signal of others, would materially increase the asserted danger of cross-subsidization; that regulators would freely permit the recoupment from politically-sensitive services such as basic local residential service, of costs that could or should have been assigned to video; and that the telephone companies would, as a result, be able to drive their cable competitors from the market. All of these beliefs are in my opinion erroneous.

(5) The asserted danger of cross-subsidization, as described by both the Department of Justice and the NCTA, arises almost exclusively from the fact that the telephone network is evolving into a facility capable of carrying voice, data and video images. Cable systems too are developing these same capabilities. This kind of joint or common use is not an evil in itself: on the contrary, it is a source of efficiency—a clear exemplification of what economists refer to as economies of scope. It does

increase the importance of the issue, particularly in a regulated industry, of how the common costs are to be distributed among those several services. This is not a new regulatory problem in telephony: regulators have long ago developed methods of separating the costs of telephone service subject respectively to state and to federal regulation. They have also devised and prescribed methods of assigning or allocating joint and common costs among the various individual services subject to their respective jurisdictions. Intervenors have the right to contest these methods in regulatory proceedings and rights of appeal if they are not satisfied with the agency's determinations.

(6) As the foregoing discussion makes clear, the danger of cross-subsidization typically arises in situations in which significant portions of the costs of competitive and monopoly services are common to both. If some of these costs are improperly shifted from the former to the latter and recovered in the charges for the monopoly services, this could indeed confer an unfair advantage on the telephone company in its competitive markets, and could conceivably enable it to drive its competitors out of business. The question is whether this hypothetical scenario fits the facts and the probabilities associated with the legal issue now before this Court. I conclude emphatically that it does not.

(7) First, it cannot be overemphasized that what is at issue in this case is the plaintiffs' authority to engage in video programming, not their already acknowledged authority to provide video transmission. It is difficult to conceive that there could be any substantial costs common to the transmission of video and other telephone signals, on the one side, and the creation and packaging of video programming on the other. Numerous authorities, including the defendants, have actually conceded this fact. For example, NCTA, through economist Dr. Owen, admits that the defendants' cross-subsidy scenario requires

the presence of common costs[1] and that there are no substantial costs common to both video transport and programming.[2] And the Department of Justice has conceded elsewhere that "information services that involve primarily the provision of content or the processing of information . . . would be likely to share fewer facilities or personnel with [telephone company] local exchange operations [than transmission services]. . . . [T]he potential for misallocation of costs in violation of allocation regulations is minimal and even more easily detected by regulators where there is a relative paucity of joint and common costs between telephone exchange operations and ventures in the new market."[3] The statutory ban at issue here applies not to a service that, in the words of the Department, involves "*primarily* the . . . content of information"; it applies to a service that involves *only* content. There is therefore no rational connection between the defendants' cross-subsidy argument and the ban against telephone companies providing video *programming*.

(8) In the interest of a complete response, however, I have considered whether, if the prohibition at issue here is lifted, the telephone companies might, as Dr. Owen contends, be in a position somehow to cross-subsidize their video transmission services at the expense of other, monopoly services. In my view this is highly unlikely—unlikely that they would be permitted, and even if per-

---

[1] *E.g.*, Owen Aff. at 15.

[2] *E.g.*, Owen Aff. at 4 ("there are no obvious economies of scope or of vertical integration arising from both laying fiber optic cable and producing or buying and then packaging video programming"); *see also* NCTA Mem. 23, *United States v. Western Elec. Co.* (D.D.C. filed Oct. 17, 1990), ("it may well be, as the Huber Report says, that opportunities for cross-subsidization may be few in the creation of programming").

[3] Mem. of the United States at 34, *United States v. Western Electric Co., Inc.*, (D.D.C. filed Aug. 22, 1990).

mitted, able to do so. As for the first, I am advised by counsel that video transmission services are subject to federal, not state regulation. The principal other services subject to that jurisdiction are the "access" to or interconnection with the local exchange network that telephone companies provide to long distance carriers such as AT&T for the origination and termination of long distance calls. The FCC's method of regulating these charges does not automatically permit raising them whenever the providers' overall earnings decline; and its cost allocation rules, to which I have already referred, prohibit that kind of cross-subsidization.

(9) As to the *ability* of the telephone companies to raise their rates for these access services, these charges constitute approximately 40% of the long distance carriers' total operating costs. Entirely apart, then, from whether the FCC would *permit* the requisite increase, the resistance on the part of the customers would be intense, and effective. These are very sophisticated carriers, with every incentive to avoid improper cost shifting to their injury. And they have the protection, increasingly, of competition, and will have it even more in the future, as alternative providers of access services have emerged to handle the origination and termination of long-distance traffic, particularly of large governmental and business installations. The recently announced multi-billion dollar TimeWarner/US West transaction is premised on the fact that cable systems, which now reach 96 percent of all households, can be modified to provide this same access service, in competition with local telephone companies, for small as well as large customers. MCI, similarly, has announced its engagement in active negotiations with cable companies, with the same purpose in mind. For these many reasons I conclude that there is no significant danger of successful cross-subsidization even of video transmission by telephone services—whether or not the telephone companies are permitted to engage in video programming.

(10) Recovery of any such subsidies at the intrastate or local level is similarly highly unlikely, and becoming increasingly so every day. Entirely apart from the question of the willingness of state regulators to permit it, local service is becoming increasingly competitive. NCTA itself describes the cable industry as a "serious source of potential competition for residential telephone service." [4] Furthermore, the divestiture of AT&T has spawned a host of actual and potential competitors previously all part of that single corporate entity. Southwestern Bell, for example, has acquired cable systems in the Washington area, including Northern Virginia, which position it to provide not just video but competitive access services of the type contemplated also by the U.S. West/Time Warner transaction. Southwestern Bell also provides wireless services in this area. AT&T has already purchased a multi-billion dollar stake in wireless services competitive or potentially competitive with the incumbent local telephone companies; and the trade journals report that MCI likewise intends to enter the local exchange business with wireless technology. The FCC is actively promoting expansion of this competition—for example, by allocating additional spectrum to new wireless services and requiring the telephone companies to provide interconnection with all competitive access providers.

(11) At least equally important, state regulators have historically been very reluctant to raise residential telephone rates, for obvious political reasons. Consequently, even if the costs of video programming could be misassigned to transmission services, and misassigned again over the federal-state jurisdictional boundary to local exchange services, it is certain that the regulators would resist the requisite compensatory price increases. If the state regulatory commissions may be said to have had one overriding goal historically, it has been to hold down the price of basic residential telephone service; and they have done so

---

[4] Owen Aff. at 31.

to the point of holding those prices inefficiently low and requiring inefficiently high charges for "vertical" or "enhanced" services. Far from permitting cross-subsidization of competitive by monopoly services, regulators have typically handicapped telephone companies in the competitive markets—inefficiently so.

(12) As the defendants themselves point out,[5] the cross-subsidization they predict is possible only to the extent a telephone company's services are subject to cost-based, rate-of-return regulation. The kind of recoupment they posit was never automatic, even under that traditional regulatory practice: rates were altered only periodically and raised only when achieved rates of return fell outside an acceptable range.

(13) In both 1970, when the FCC first adopted the prohibition at issue here, and 1984, when Congress enacted it, telephone companies were in fact universally subject to traditional rate-of-return regulation. Today, in contrast, the FCC and a majority of state regulators have substantially modified that form of regulation in favor of price freezes or caps, which fix the *price* of services rather than telephone company *profits*, or other "incentive" regulatory arrangements that permit company profits to fluctuate within a wider than traditionally permitted range, with or without automatic sharing with ratepayers of profit surpluses or deficiencies. All of these plans, by further weakening any previous assurances of automatic recovery from less competitive services of net revenue losses from competitive ones, have the effect of weakening any incentive or ability the telephone companies may previously have had to cross-subsidize competitive services at the expense of others less subject to competition. Indeed, prevention of cross-subsidy has been one central, explicit reason for the adoption of these reforms. The very fact that it is the telephone companies themselves that have been the principal proponents of these plans further contradicts

[5] *E.g.*, Owens [*sic*] Aff. at 15.

the defendants' contentions that they would respond to removal of prohibitions on their entering various competitive businesses with a strategy of cross-subsidy. Under the various forms of incentive regulation, the incurrence of "losses" on competitive business would simply decrease their profits. Significantly, even NCTA concedes that a pure price cap arrangement would "reduce or eliminate the incentive to shift costs to regulated services." [6]

(14) There are some respects in which the arguments of the defendants do not rest entirely on the presence of common costs, on the one side, and of the opportunity to recover the burdens of cross-subsidy via cost-plus regulation on the other. For example, one of the amici on the side of the cable industry argues that the telephone companies would have an unfair advantage by virtue of their ability to "cherry pick personnel" from their telephone operations for the benefit of their video programming services.[7] But, as the DC Circuit has observed with admirable conciseness, "[r]unning a local [telephone] exchange does not require reporters, copy editors, joke writers, financial analysts, astrologists, or other information-content providers" [8]—to which list one might add screen writers, Hollywood stars and game show hosts.

(15) Dr. Owen's affidavit on behalf of NCTA also cites, as an asserted unfair advantage of telephone companies, their ability to raise capital for the combined enterprise on more favorable terms than their cable competitors. First of all, the opinion he expresses that the overall cost of capital of well-managed cable companies is higher than of telephone companies is a mere undocumented assertion on his part. In any event, the sufficient response

---

[6] Owen Aff. at 23.

[7] Brief of Amici Curiae Consumer Federation of America, *et al.*, at 22 (dated May 21, 1993).

[8] United States v. Western Electric Co., 900 F. 2d 283, 308 n. 28 (D.C. Cir. 1990).

is that nowhere in the economist's conception of the prerequisites of effective competition or in the antitrust laws, to my knowledge, has the mere possible ability of one company to raise capital on more favorable terms than another been regarded as providing a sufficient basis for excluding that company from the opportunity to compete with others putatively less advantageously situated in that respect.

(16) Finally, Dr. Owen's asserted concern that a telephone company could engage in "self dealing" by paying a programming affiliate inflated prices for its programming has the facts completely backwards. It is not the telephone company that proposes here to purchase programming from an affiliate. It is the programming affiliate that would buy video transport service from the telephone company, at tariffed rates. And of course the affiliate would have every incentive to produce and acquire programming as economically as possible, since it would be in the business of offering it to subscribers, for whose patronage it would be competing with the cable companies.

(17) Finally, I find the ultimate essential component of the successful strategy of cross-subsidy and predation hypothesized by the defendants in this proceeding—namely the permanent removal of competitors—highly improbable in the present circumstances. The cable companies have installed networks capable of serving 96% of all households. That capacity is not going to go away. The marginal cost of operating these systems must be relatively low, leaving their operators with latitude for price reductions more than sufficient to discourage any would-be predator. It is the cable companies that are the dominant incumbents in the video entertainment market, with access or contractual rights to the most popular entertainers and shows. Their facilities also have the potential to be upgraded to provide two-way communications services, which could produce an enormous supplemental revenue stream. In the circumstances I find it simply inconceivable that they will or could be driven out of business by the mis-

assignment of the costs of telephone company video services.

CONCLUSION

There is no economic basis for the expectation that permitting the telephone companies to provide video programming directly to the public within their service areas would put them in a position to deny the cable companies a fair opportunity to compete or, through cross-subsidization, to drive them from the market.

/s/ Alfred E. Kahn
ALFRED E. KAHN

[Notarization Omitted in Printing]

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF VIRGINIA
(Alexandria Division)

[Caption Omitted in Printing]

AFFIDAVIT OF PATRICIA S. TICER

COMMONWEALTH OF VIRGINIA)
) to wit:
CITY OF ALEXANDRIA)

Patricia S. Ticer, being duly sworn, deposes and says as follows:

1. I am the Mayor of the City of Alexandria, Virginia, and have held that position since 1991. Prior to that, I served as a member of the City Council for 8 years.

2. On June 26, 1991, I testified before The United States House of Representatives, Committee on Energy and Commerce Subcommittee on Telecommunications and Finance, on behalf of the National League of Cities and the United States Conference of Mayors with respect to telephone company provision of cable television services. I testified in favor of telephone company entry into the cable market subject to appropriate regulatory safeguards. I continue to believe that competition provided by telephone companies is in the public interest and, specifically, in the best interests of the residents of the City of Alexandria.

3. If the prohibition contained in Section 533(b) of the 1984 Cable Act were removed, and the Chesapeake and Potomac Telephone Company of Virginia and Bell Atlantic Video Services Company were to make application for a franchise pursuant to Title 9, Chapter 3 of

the Alexandria City Code, the application would be acted upon by the Alexandria City Council, and would receive the same consideration as the application of any other applicant.

/s/ Patricia S. Ticer
PATRICIA S. TICER

[Notarization Omitted in Printing]

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF VIRGINIA
(Alexandria Division)

[Caption Omitted in Printing]

AFFIDAVIT OF JEAN POOL

1. I am Senior Vice President, Director of Local Market Broadcast for J. Walter Thompson. I manage a negotiating unit comprised of 136 specialists located in seven major markets across the U.S. We purchase commercial airtime on radio, television, and local cable systems on behalf of J. Walter Thompson clients including Bell Atlantic. I am knowledgeable about the practices of the cable industry with respect to the selling of airtime.

2. On May 25, 1993, we made an inquiry to Jones Intercable to determine whether it would be possible to lease a channel on its cable system in Alexandria, Virginia. Jones said it has no channels available for leased access in Alexandria. Jones, however, will lease time slots, subject to availability, in half hour increments.

3. Jones Intercable, as is the case with all other local cable companies, reserves the right to view proposed programming prior to air. This is typically how all broadcast stations operate also.

4. Based on my experience buying time on cable systems, I believe that Bell Atlantic would be unlikely in most communities to be able to lease even one channel from the local cable operator. Cable systems typically are already filled to capacity with programming and are unwilling to bump existing programs to make room for leased access users. In most instances, therefore, Bell Atlantic would be limited to leasing short, individual

time slots subject to availability and subject to the editorial preview of the cable operator.

I declare under penalty of perjury under the laws of the United States of America that the foregoing is true and correct. Executed on 6-2-93.

/s/ Jean Pool
JEAN POOL

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF VIRGINIA
(Alexandria Division)

[Caption Omitted in Printing]

AFFIDAVIT OF ROBERT L. TOWNSEND

1. My title is Director of Bell Atlantic Video Services Company ("BVS"). I have worked in the cable TV Industry for over a decade. Before joining BVS, from 1989 to 1992, I was Senior Vice President of a subsidiary of the Home Shopping Network, which is a producer of video programming sold to cable systems. Prior to that, from 1981 to 1989, I was Vice President, Sales, Marketing, and Programming of New York Times Cable TV. In addition, I have served as a member of the board of directors of the Cable Television Administration and Marketing Society ("CTAM") and was President of the Northeast Region of CTAM. I have substantial experience—from the perspectives of both a cable operator and an independent video programmer—in buying and selling video programming.

2. I submit this affidavit in response to the government's claim that the prohibition in this case does not "unduly burden" BVS's ability to provide video programming in its telephone affiliates' service areas. Gov't Mem. 66.

3. The government claims that, despite the prohibition, BVS could sell programming to existing television networks and could acquire a local television broadcasting station. Gov't Mem. 66. The Newspaper Association, unlike the government, claims that BVS could acquire broadcast stations only outside its telephone affiliates'

service areas. NAA Mem. 12. On the other hand, the Newspaper Association claims that BVS could lease channel capacity from existing cable operators. NAA Mem. 11. The NCTA claims that BVS could offer programming to existing broadcast television stations, cable operators, movie theaters, or video stores. NCTA Mem. 56. The National Association of Broadcasters claims that BVS is barred from all in-region video programming. NAB Mem. 32. Despite the differences in these parties' views regarding what is permitted, they all—except for the broadcasters—suggest that there exist ample alternative means for BVS to distribute its video programming even within its telephone affiliates' service areas.

4. Assuming for purposes of this affidavit that the proposed alternatives are all legally permitted, they in fact do not provide BVS a meaningful opportunity to provide video programming of the type and in the quantity that it seeks to provide. The problems with these alternatives are discussed below.

5. Many of the alternatives would subject BVS's programming to the editorial discretion of the existing program distributors. Cable operators and television broadcast stations have no obligation to purchase BVS's programming. BVS's ability to get its programming shown in any particular geographic area would be entirely subject to the whim of cable companies and broadcasters.

6. NCTA states that BVS could simply create and market the "Bell Atlantic Hour" for carriage on local cable systems. NCTA Mem. 56. NCTA chose this example very carefully. As described in Jean Pool's affidavit, the "Bell Atlantic Hour" is near the maximum amount of air time that a typical cable system will sell to an independent programmer. But even shorter time slots can be difficult to arrange if the content of the programming is disagreeable to the cable operator. In November 1991, one of Bell Atlantic's companies, New Jersey Bell, produced a 30-second commercial advertisement

regarding a bill pending before the New Jersey legislature. Suburban Cable, a large cable operator in Northern New Jersey which opposed the bill, initially refused to carry the commercial. After a period of negotiation, Suburban Cable agreed to carry the commercial but insisted on running its own commercial immediately afterward responding to New Jersey Bell's commercial. The result was to confuse and adulterate the message New Jersey Bell was trying to present. In a subsequent complaint proceeding before the New Jersey Board of Regulatory Commissioners, Suburban Cable defended its actions as "editorial discretion." Answer to Petition at 3, BRC Docket No. CC91121783 (Dec. 20, 1991).

7. Suburban's standard term sheet (copy attached) provides that "Suburban Cablevision shall have the right to approve or disapprove all materials submitted for cablecasts" and that its "right of disapproval shall be exercised in its sole discretion as to any matter it deems objectionable for any reason whatsoever." Suburban's term sheet is typical. The standard term sheet (copy attached) currently in use by Mega Advertising, which arranges airtime on behalf of cable systems in the Washington, D.C. metropolitan area, provides that "[a]ll programs" are subject to "prior approval." Programs will not be aired if, in Mega Advertising's "sole discretion," they are "determined to be unsatisfactory, unsuitable or contrary to the public interest."

8. None of the proposed alternatives would permit BVS to provide more than a channel or two of programming. For example, buying a local broadcast television station, as the government suggests, would allow BVS to program one channel. Most cable operators today offer 30 to 53 channels. BVS's programming plan for Alexandria includes approximately 100 channels. To fit within the alternatives, BVS would have to abandon 99% of its programming plan.

9. Moreover, relegating BVS to begging and borrowing space from the existing program distributors would

not promote programming diversity. Rather it would ensure that there is no net increase in the amount of programming. Whatever programming BVS would show would simply displace other programming.

10. None of the alternatives would permit BVS to offer video on demand service. This service requires the technical ability to address individual subscribers and to deliver to subscribers specific programs that they order. This service also requires a return communication capability so that the subscriber can select a video, pause it, restart it, and perform other functions to interact with the video. To my knowledge, there is no cable system or broadcast station in the Bell Atlantic region that employs the type of technology needed for this service. Requiring BVS to provide programming over the existing media, therefore, has the effect of barring this new service.

11. Video on demand is qualitatively a different type of programming than traditional broadcast or cable. From the customer's perspective, video programming that a broadcaster or cable operator has pre-selected is not a substitute for programming that the customer selects herself.

12. Finally, the Newspaper Association's suggestion that BVS lease channels from existing cable operators is not a viable alternative. Leased access has been available since 1984, but programmers have made "scant use of the leased access channels." *Report and Order, In the Matter of Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992, Rate Regulation*, MM Docket 92-266, at 318 (released May 3, 1993). There have been severe problems with leased access arrangements. Among other things, cable operators charged high rates, subjected programmers to the cable operators' editorial control, and provided no mechanism for billing subscribers on behalf of the leased access programmers. The House Report ac-

companying the 1992 Cable Act concluded that "leased access has not been an effective mechanism for securing access for programmers to the cable infrastructure or cable subscribers." H. Rep. No. 102-628 at 39. Pursuant to the 1992 Cable Act, the FCC recently issued rules attempting to rectify some of the deficiencies in leased access. However, the FCC cautioned that its rules are to be "understood as a starting point that will need refinement." *Report and Order*, MM Docket 92-266, at 306 (released May 3, 1993). Time Warner has filed a First Amendment challenge to the leased access requirements on the ground that they would interfere with its "editorial discretion." Complaint for Declaratory and Injunctive Relief at 44-45, *Time Warner Entertainment Co. v. FCC*, No. 92-2494, (D.D.C. filed Nov. 5, 1992).

13. In any event, leased access would allow only a small amount of programming. A cable system the size of Jones's system in Alexandria would be required to make available a total of four channels. If multiple programmers seek access to these channels, under the FCC's rules BVS "will only be allowed to lease up to one channel's capacity." *Report and Order*, MM Docket 92-266, at 310 (released May 3, 1993). Leased access, therefore, involves most of the problems of the other alternatives.

I declare under penalty of perjury under the laws of the United States of America that the foregoing is true and correct.

Executed on 6/3/93.

/s/ Robert L. Townsend
ROBERT L. TOWNSEND

SUBURBAN CABLEVISION TERMS AND CONDITIONS

GENERAL TERMS AND CONDITIONS

Agency and client are both jointly and separately responsible for all terms and conditions of this contract.

* * * * *

Cablecast Approval

Suburban Cablevision shall have the right to approve or disapprove all material submitted for cablecasts hereunder and to refuse to permit any individual to participate in any cablecast. Suburban Cablevision's right of disapproval shall be exercised in its sole discretion as to any matter it deems objectionable for any reason whatsoever. The Advertiser/Client should submit any questionable matter to Suburban Cablevision for a determination of the permissibility of its use before contracting any obligations or commitments in connection therewith.

All programs and production material remain the property of Suburban Cablevision unless exempted in this agreement.

* * * * *

CONDITIONS

The advertiser and its agency, if any, (collectively, "ADVERTISER") purchasing broadcast time for the announcements or programs provided for in this contract and such talent as is specified herein. Mega Advertising hereby agrees that this contract shall be governed by the following terms and conditions:

* * * * *

5. PROGRAMS AND COMMERCIAL MATERIALS

* * * * *

(b) All programs or announcements to be broadcast are subject to the prior approval of Mega Advertising,

and Mega Advertising without restriction or liability reserves the right to refuse to broadcast any program or announcement that Mega Advertising, in its sole discretion, determined to be unsatisfactory, unsuitable or contrary to the public interest.

* * * * *

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF VIRGINIA
(Alexandria Division)

[Caption Omitted in Printing]

SUPPLEMENTAL AFFIDAVIT OF WILLIAM E. LEE

1. In my affidavit of April 27, 1993 I demonstrated that the creation, selection, arrangement, packaging, and provision of video programming for multichannel delivery, whether performed by a cable company or by Bell Atlantic Video Services ("BVS"), involves editorial decisions that are functionally indistinguishable from those involved in newspaper editing. None of the parties challenging the plaintiffs' motion for summary judgment have disputed that point. However, they have sought to distinguish telephone companies from newspapers, suggesting newspaper do not receive government-bestowed benefits as telephone companies do. In this supplemental affidavit, I briefly describe the extensive and valuable benefits conferred upon newspapers by federal, state, and local governments.

2. In its Memorandum, the United States claims that the plaintiffs depend upon federal and state government for acquisition and maintenance of their monopoly of local telephone service. Mem. of United States at 44. *See also* Mem. of NCTA at 4 & 43 (local telephone companies are the recipient of a valuable government grant). The United States also claims that the plaintiffs depend upon government for use of rights-of-way. Mem. of United States at 60. The United States argues that the print medium "has never enjoyed any remotely similar set of government-bestowed benefits." *Id.* at 44 n.41. In their brief, the Newspaper Association of America and the Virginia Press Association make similar claims concerning government-conferred monopoly status, but

add that telephone companies use the electromagnetic spectrum as well as public rights-of-way. Brief Amici Curiae of NAA and VPA at 23-24.

3. Among the benefits conferred upon newspapers by the government are the following:

a. Competition between separately owned local daily newspapers is exceedingly rare. In 1992, daily newspapers were published in 1,513 U.S. cities. Only 37 cities had two or more separately owned, competing dailies; 19 of these cities had newspapers published under joint-operating agreements which allow papers to merge activities such as advertising and printing. Newspaper Association of America, *Facts About Newspapers 92* at 26 (1992). In *Citizen Publishing Co. v. United States*, 394 U.S. 131 (1969), a joint-operating agreement was found to be a violation of the antitrust laws because it involved price fixing and profit pooling, and restricted entry into the market. Congress responded by conferring upon the newspaper industry one of the few limited exemptions from the antitrust laws. The Newspaper Preservation Act, 15 U.S.C. §§ 1801-1804, permits newspapers that maintain separate editorial staffs to combine their printing, distribution, advertising, circulation, and business departments. The joint-operating agreements authorized by the Act eliminate advertising competition among the jointly operated papers, and create cost savings that place actual and potential competitors at a marked disadvantage. Many commentators have criticized the Act as being anticompetitive. *See, e.g.*, Flynn, *Antitrust and the Newspapers: A Comment on S. 1312*, 22 Vand. L. Rev. 103 (1968); Knox, *Antitrust Exemptions for Newspapers: An Economic Analysis*, 1971 Law & Soc. Ord. 3; Comment, *The Newspaper Preservation Act*, 32 U. Pitt. L. Rev. 347 (1971). As the Court of Appeals for the Ninth Circuit wrote, Congress was aware of the Act's anticompetitive effects, but made a policy determination that other considerations, such as preserving editorial di-

versity, were paramount. *Committee for an Independent P-I v. Hearst Corp.*, 704 F.2d 467, 481-82 (9th Cir. 1983).

b. Newspapers receive preferential rates and expedited delivery from the United States Postal Service. *See* United States Postal Service, *Domestic Mail Manual* at 371-491 (1992) (discussing second-class mail policies and procedures). This preferential treatment, designed to encourage the circulation of newspapers, originated with Benjamin Franklin and has continued to the present. *See generally* W. Fuller, *The American Mail: Enlarger of the Common Life* at 122-27 (1972) (discussing 19th century postal laws favoring newspapers). Prior to the reorganization of the Post Office in 1970, rates for mail delivery of newspapers were heavily subsidized; second-class mail contributed only 3% of postal revenues but accounted for 11% of total postal volume. G. Cullinan, *The Post Office Department* at 240 (1968). The amount of the subsidy has been reduced as the reorganized Postal Service attempts to become self-supporting, but Congress continues to appropriate funds to subsidize second-class mail. Rambo, "Newspaper and the Postal Service," *Presstime*, Jan. 1986, at 20.

c. The importation of newsprint is duty-free. United States International Trade Commission, *Supplement 1 to the Harmonized Tariff Schedule of the United States* at 48-5 (1992). The absence of a duty significantly benefits newspaper publishers for two reasons. First, American newspapers import as much as 60% of the newsprint they use, primarily from Canada. Deutsch, "Bags and Boxes Full of Profits," *New York Times*, Aug. 14, 1988, at sec. 3, p. 1. Second, newsprint accounts for as much as 33% of the cost of publishing a daily newspaper. C. Fink, *Strategic Newspaper Management* at 78 (1988). This is second only to labor in publishing expenses. *Id.* at 77-78; J. Udell, *The Economics of the American Newspaper* at 118-24 (1978).

d. Newspaper employees involved in delivery are exempt from certain provisions of the Fair Labor Standards Act, 29 U.S.C. § 213 (d). State labor laws also exempt newspaper carriers from collective bargaining, and minimum-wage and age requirements. *See, e.g.*, West's Rev. Code Wash. Ann. § 49.46.010(f) (Supp. 1986); Pa. Stat. Ann. tit. 43 § 33.105(3) (Purdon Supp. 1985); Mass. Ann. Laws ch. 49 § 69 (Michie/Law Co-op. 1976). Although the percentage of youth newspaper carriers has been declining in recent years, in 1992, youth carriers constituted 65.7% of total U.S. daily carriers. Newspaper Association of America, *Facts About Newspapers 92* at 25 (1992).

e. Newspapers are extensive users of the FCC-regulated spectrum. First, newspapers today receive information via communications satellites. This information includes news stories, photographs, and graphics from services such as the Associated Press, United Press International, and Reuters. Bacon, "Satellites Make Big Impact at Newspapers," *Presstime*, Aug. 1988, at 6. The use of communications satellites has also fostered the growth of supplemental news services such as Scripps Howard News Service, Los Angeles Times-Washington Post News Service, New York Times News Service, and Knight-Ridder/Tribune News Information Service. W. Agee, P. Ault & E. Emery, *Introduction to Mass Communications* at 148 (10th ed. 1991). Additionally newspapers receive national advertisements via satellite from the AD/SAT company. *Id.* at 430. Second, newspapers send finshed pages to printing plants via terrestial microwave links or communications satellites. For example, the *Washington Post* sends pages to printing plants in the District of Columbia and Springfield, Virginia via microwave; the *New York Times* links its New York offices with a printing plant in Edison, New Jersey via satellite. National newspapers, such as the *Wall Street Journal, Christian Science Monitor, USA Today,*

and the *New York Times* national edition, send pages to printing plants, throughout the country via satellite. *See, e.g.* "Nationalizing the New York Times," *Editor & Publisher,* Jan. 21, 1984, at 36-37 (describing the technology used in satellite transmission of newspaper pages). Third, newspapers are experimenting with use of the spectrum to reach the consumer. For example, Knight-Ridder, one of the nation's largest newspaper chains, is developing a hand-held notebook computer designed to receive newspaper content via satellite. Reilly, "Publishers Design Electronic Newspapers to Keep Control of Information Delivery," *Wall Street Journal,* Feb. 26, 1993, at B1.

f. Most states exempt newspapers from sales tax. A 1986 study of newspaper taxation found only 12 states imposing taxes on newspaper circulation. "Six States Now Tax Some Form of Advertising, but the Number Taxing Newsprint and Ink Declines," *Presstime,* Feb. 1986, at 42. Only two states tax the purchase of materials such as ink and newsprint used to produce newspapers. *Id.*

g. Some states have enacted retraction statutes providing special protection for newspapers in defamation actions. These statutes preclude the award of a class of damages, or mitigate damages. Three of the 33 states with retraction statutes apply this protection only to newspapers; 8 limit it to newspapers and periodicals; 14 cover both print and broadcast media, and 8 cover any defendant. R. Sack, *Libel, Slander, and Related Problems* at 379 (1980).

h. Newsracks are often placed on city property such as sidewalks and the United States Supreme Court recently noted the importance of this form of distribution. *City of Cincinnati v. Discovery Network, Inc.*, 61 U.S.L.W. 4272, 4273 n.10 (U.S. Mar. 24, 1993) ("almost half of the single copy sales of newspapers are now distributed through newsracks"). In general, newspaper

publishers do not pay municipalities a fee for placement of newsracks on public property.

4. As this affidavit reveals, the claim that the newspaper industry does not receive valuable and extensive benefits from the government is clearly false. Government-conferred benefits pervasively affect newspaper publishing on a daily basis and increase newspaper profitability.

I declare under penalty of perjury under the laws of the United States of America that the foregoing is true and correct. Executed on June 3, 1993.

/s/ Wm. E. Lee
WILLIAM E. LEE

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF VIRGINIA
(Alexandria Division)

[Caption Omitted in Printing]

AFFIDAVIT OF H. R. STALLARD

1. I am the President and Chief Executive Officer of The Chesapeake and Potomac Telephone Company of Virginia ("C&P"). I joined the company in 1959 as a Staff Assistant-Engineer and had various positions of increasing responsibility until I was appointed to my present position in 1988. This affidavit responds to several matters raised by the government, NCTA, and others who filed briefs opposing our provision of video programming.

2. *Rate regulation.* Bruce Owen's affidavit claims that "local telephone companies characteristically are subject to cost-based regulation." This was true in 1970, but the fact is that telephone regulation is moving away from cost-based formulas toward priced-based systems that reward companies if they reduce costs and penalize them if costs increase. C&P's interstate telephone services are subject to regulation known as "price caps." Under a formula established by the FCC, C&P's charges for interstate services may not exceed a specific "cap." Each year, the cap is adjusted by the actual amount of inflation minus a fixed downward adjustment of 3.3% for assumed productivity gains. The resulting formula ensures that prices decrease year after year in real, inflation-adjusted terms.

3. At the state level, C&P is currently regulated under an experimental regulatory plan effective in 1989

which incents the company to avoid rate increases altogether. Under this Plan, C&P has not increased its basic schedule of rates. In fact, C&P has not increased its rate schedules since January, 1984, and C&P has actually reduced rates significantly since that time. The State Corporation Commission is currently evaluating the effectiveness of its Experimental Plan and is considering modification to it. The Virginia General Assembly enacted legislation, effective July 1, 1993, that specifically empowers the Commission to adopt new forms of regulation which are not cost-based. (A copy of the legislation is included in plaintiffs' document appendix, vol. IV, tab 52.) The legislation requires that any new form of regulation provide safeguards to "assure that there is no cross subsidization of competitive services of a telephone company by monopoly services." C&P will ask the State Corporation Commission under this legislation to modify regulation in such a way that C&P's rates for basic service will be capped for a number of years and can be increased thereafter only at a fraction of the increase in the rate of inflation. We will specifically request that the Commission adopt this regulatory plan so as to decouple the relationship between prices of regulated basic services and their costs.

4. Owen and others claim that C&P will subsidize its Alexandria video transport network by raising rates. However, as I have stated, the curent [*sic*] regulatory environment in Virginia will not permit this to happen. Moreover, when C&P filed this lawsuit, it committed to the State Corporation Commission that it will not, in any event, seek to increase rates for basic telephone services as a result of its investment in Alexandria to enhance its telephone network to carry video. (See my letter of December 17, 1992, to the Commission and the December 21, 1992, response from Hon. Preston C. Shannon, attached.)

5. Owen's cross subsidy theory would also apply to other competitive services that C&P and its affiliates are permitted to provide. C&P and its affiliates provide a number of information services and a number of other services which are competitive with those offered by non-regulated or lightly-regulated firms. Yet, nowhere in the government's document submission nor in the submissions of the government's amici is there any allegation that C&P has engaged in cross subsidy. For example, the provision of access service from a customer's location to a long distance company's switch is increasingly competitive. But C&P is not increasing any of its basic service rate schedules to offset competitive losses or to subsidize competitive access services. In fact, basic rates have been stabilized or decreased.

6. *Transactions between C&P and BVS.* Owen claims that BVS intends to sell video programming to C&P. Such sales allegedly would allow C&P "to increase the apparent costs and therefore the permitted price of the regulated service." Owen claims that these sales will create "a substantial opportunity to engage in cross-subsidization." Owen, however has the facts backwards. BVS will not be selling programming to C&P; instead, C&P will be selling tariffed video transport to BVS as well as to other unaffiliated programmers on the same terms. BVS's programming will not be part of C&P's costs of regulated service.

7. The government claims that there are state law obstacles to C&P's provision of tariffed video transport services to BVS. C&P, however, currently provides tariffed services to various corporate affiliates. For example, C&P provides tariffed telephone services to its affiliate, Bell Atlantic Mobile, which provides cellular telephone service. C&P has neither sought nor obtained approval for the provision of these services from the State Corporation Commission under the statutory provisions the government cites. I am advised by counsel that such approval is not required for the provision of tariffed

services to affiliates and, to my knowledge, the State Corporation Commission has never required such approval. Nor has the fact that some of C&P's affiliates engage in non-telephone businesses, which C&P itself might be barred from engaging in, ever presented an obstacle to C&P's provision of tariffed services to them.

8. *Pole attachments.* The government alleges that "within six months of entering the cable television market, C&P could cripple the only competition" by terminating its agreements with cable operators respecting pole attachments. This prediction is not reflected in experience. C&P is in competition with cable companies today. Nonetheless, as far back as C&P's records go, C&P has not terminated an agreement for pole attachments or conduit with a cable company that was providing cable service to customers.

9. To eliminate any uncertainty about C&P's willingness to renew its agreement with Jones Intercable respecting pole attachments and conduit in Alexandria, C&P has offered to extend the agreement for the 20-25 year term of Jones's renewal of its cable franchise. (See the attached letter from James E. Howerton to Sherry Gilmore of Jones Intercable.)

10. *Franchise.* The government and others claim that the ban on video programming is justified by the fact that telephone companies have franchises to provide telephone service. C&P has certificates of convenience and necessity, issued by the State Corporation Commission, to provide local exchange and toll telephone services in many areas of the Commonwealth, including the City of Alexandria, Virginia. (The Alexandria certificate is included in plaintiffs' document appendix, vol. IV, tab 53). These certificates are not conditioned on C&P or its affiliates refraining from providing video programming.

11. Not all telephone companies have franchises, and some telephone companies have franchises that are non-exclusive. For example, C&P's affiliate, The C&P Tele-

phone Company of Maryland, has no franchise. Another of C&P's affiliates, The Chesapeake and Potomac Telephone Telephone Company, which provides telephone service in the District of Columbia, has a franchise that is non-exclusive.

12. *Alleged protection from competition.* The government and others also claim that the ban on video programming is justified by the fact that the government is supposedly protecting telephone companies from competition. In fact, the federal government has spent the last two decades promoting competition in the telephone business, preempting state law where necessary.

13. In 1970, C&P was the sole provider of telephone handsets and other customer telephone equipment in the parts of Virginia where it provides telephone service. In the late 1970s, the FCC mandated competition for equipment. The Bell Companies continue to provide telephone equipment but, according to statistics compiled by the trade association of equipment suppliers, they collectively supply only about 10% of U.S. purchases.

14. In 1970, C&P was the sole provider of pay telephones in the parts of Virginia where it provides telephone service. In 1984, the FCC opened up competition for pay telephones and preempted conflicting state laws. Today, the number of pay telephones provided by competitors is growing at the rate of 20% per year and the number of C&P's pay telephones is declining.

15. In 1970, C&P was the sole provider of local telephone services in the parts of Virginia that it serves. This was largely true even in 1984. In 1991, the FCC announced that it would promote competition in local telephone services used to originate and terminate interstate calls by requiring C&P and other telephone companies to provide new forms of interconnection with the competitive access providers ("CAPs"). Today, C&P faces competition from CAPs such as Metropolitan Fiber Systems, which provides services in Northern Virginia.

And in Richmond and in Norfolk, cable companies serving those areas are rapidly positioning themselves to provide competitive access service.

16. In 1970, there were virtually no mobile radio services in competition with local telephone services. In the early 1980s, the FCC began issuing spectrum licenses to cellular radio providers. In 1984, 32 systems had been licensed, serving some 92,000 subscribers. Today, as the parties have stipulated, licenses have been issued nationwide, there are 11,000,000 cellular subscribers, and the number of subscribers is growing 40% per year.

17. The FCC has begun licensing additional radio-based telephone service providers. The amount of spectrum to be licensed by the FCC is many times the amount allocated to current cellular providers and would be sufficient to provide telephone service to everyone in the Nation. As the parties have stipulated, the FCC has granted 203 experimental licenses for personal communication services ("PCS"), thirty five of them to cable companies. Jones Lightwave, an affiliate of Jones Intercable, holds an FCC experimental license for a PCS trial in Alexandria, Virginia. Permanent PCS licenses may be issued within a year. Under a spectrum auction bill that passed a House Subcommittee recently, the FCC would have 270 days from final passage of the bill to begin issuing PCS licenses. The same bill would preempt state entry and rate regulation of commercial mobile services including cellular service and PCS.

I declare under penalty of perjury under the laws of the United States of America that the foregoing is true and correct. Executed on 6-4-93.

/s/ H. R. Stallard
H. R. STALLARD

A Bell Atlantic Company
C&P Telephone

C&P Telephone Company of Virginia
600 East Main Street
Richmond, Virginia 23219
804-772-1591

Hugh R. Stallard
President and Chief Executive Officer

December 17, 1992

The Honorable Preston C. Shannon
The Honorable Theodore V. Morrison, Jr.
The Honorable Hullihen W. Moore
State Corporation Commission
Post Office Box 1197
Richmond, Virginia 23209

Gentlemen:

The C&P Telephone Company of Virgninia today announced plans to upgrade its telephone distribution network in Alexandria with fiber cable and associated electronics. As you know, C&P has been in the forefront of the introduction of new technology. Our announcement today expands upon that commitment and is further expression of our desire to bring the many benefits of broadband technology to our customers as quickly as economically feasible.

This acceleration of broadband technology will enable us to provide hundreds of communications channels, making possible the provision of many new services to our customers. A service that will be provided is cable TV. We will use our affiliate, Bell Atlantic Video Services Company ("BVS"), to provide this service. C&P will provide transport services on its enhanced distribution system on a common carrier and non-discriminatory basis. BVS will buy those transport services and provide pro-

grams to customers. We will provide other channels to other programmers and information providers.

Because our affiliate will provide programming, the Cable Communications Policy Act's prohibition against telephone companies providing cable TV service is applicable. We believe that the provision is unconstitutional. It violates the First Amendment right of telephone companies to provide video programming as well as the First Amendment right of subscribers to receive the video programming which C&P and its affiliated programming entity would provide. We have filed suit, therefore, in the U.S. District Court for the Eastern District of Virginia challenging the constitutionality of the Act. A copy of our complaint is enclosed.

Cable companies are increasingly entering the telephone business. They fight entry by others into their entrenched monopolies, as the enclosed article from *The Wall Street Journal* of September 24, 1992 illustrates. We anticipate these companies to react to our suit by challenging C&P in a number of forums, including before this Commission.

One claim that we expect is that C&P's entry into the cable business will lead to higher rates for its basic telephone service. Nothing could be further from the truth. C&P has not increased intrastate rate schedules for basic telephone service since the beginning of 1984.** We have no plans to increase those rates as a result of the planned investment.

The acceleration of the enhancement of our facilities in Alexandria is contingent upon our ability to provide cable TV and other information services. Those services will provide the revenues to support the broadband network. It is likely that our suit and related appeals will

---

* The Act applies whether C&P provides programming directly or through an affiliate. 47 U.S.C. § 533(b).

** In fact, in the intervening nine years, C&P has actually decreased those rate schedules.

take several years, and our present plans are not to proceed with the accelerated investment until successful completion of the suit.

When we do undertake this investment, we understand that the Commission certainly would scrutinize carefully any subsequent proposal to raise basic rates. Let me repeat, we have no plans to undertake any such request.

The way to provide complete assurance that rates for basic telephone service will not increase as a result of investments to provide transport for programming and information services is to decouple the relationship which exists under current regulation between costs of telephone service (rate base/rate of return regulation) and price of service. A number of States have addressed the need for a new paradigm for the pricing of telephone service, and we hope that Virginia will do likewise in the future.

If you should have any questions about our lawsuit, I would be pleased to meet with you or your staff to discuss them.

/s/ Hugh Stallard
H. R. STALLARD

Enclosure.

A14 *THE WALL STREET JOURNAL, THURSDAY, SEPTEMBER 24, 1992*

CAPTIVE AUDIENCE: ESTABLISHED CABLE-TV FIRMS SAY THEY WELCOME COMPETITION, BUT BEHAVE OTHERWISE

CABLE FIRMS SAY THEY WELCOME COMPETITION BUT BEHAVE OTHERWISE

Some Established Systems Go To Great Lengths to Keep Rivals Out of the Game

---

A Nasty Battle in Niceville

By MARK ROBICHAUX

Staff Reporter of THE WALL SREET JOURNAL

ELDOW LAKE, Minn.—This farming community has many charms: It is clean, friendly and nestled amid tiny lakes. And for a while there, residents could get paid for receiving cable television.

That is what happened when Triax Midwest Associates, an affiliate of Denver-based Triax Communications Corp., faced a challenge to its executive franchise. After years of customer complaints that Triax's service was shoddy and its rates too high, the town (pop. 1,200) decided to go into the cable business itself. It erected a 180-foot antenna across the highway from Triax's tower and hung its cables just under Triax's on the utility poles.

The municipal system quickly signed up 60% of the subscribers in town at $14.95 a month, beating Triax's

price by $1. But last summer, in the middle of a price war, Triax matched the city's rates, then flew in a legion of salespeople to go door-to-door, offering Elbow Lake citizens a rebate of $100, paid on the spot, if they agreed to sign up for a year. The city countered the next day with a monthly rate of $5.95. So did Triax. Now the town's system is struggling and faces a yearly loss. It has been forced to raise its rates back up to $14.95, and nobody knows whether the residents will stay loyal, or go for Triax's discount deals.

Slow Motion

Five years after the cable industry was deregulated, fewer than 1% of the cable markets in the U.S. are served by two or more providers, and rates have risen an average of 61% for the most popular service. Alternatives to cable, such as microwave transmission and direct-broadcast satellite reception, haven't materialized as full-fledged competitors. Complaints continue to reverberate about what many consumers perceive as cable companies' unregulated monopolies.

The bill cleared by Congress this week addresses this dissatisfaction by reimposing some community control on cable companies' behavior. The cable companies and President Bush, who says he will veto the measure, argue that the bill could actually raise costs for consumers, partly because it would enable broadcasters to obtain payments from cable companies for their signals. They maintain that competition in the cable market, not regulation, would serve consumers best.

But a close look at the few markets where entrenched cable companies have been challenged by newcomers suggests that competition is the last thing that the big cable operators want. Beyond simply playing hardball, entrenched cable operators have sought to lock out or cripple would-be competitors. They have engaged in disabling price wars, filed numerous lawsuits and hobbled

the sale of municipal competitors' bonds. They have vigorously lobbied local and state governments to keep their turf exclusive. In New York, an incumbent cable operator threatened apartment co-op boards with a halt in its service if the co-ops let a competitor in. In Cape Coral, Fla., a city famed for its Arbor Day celebrations, a cable provider charged that a would-be competitor planned to destroy 600 to 700 trees to string cable (it didn't actually plan to cut any).

'Fruits of Monoply'

"The cable industry has tasted the fruits of the monopoly and they'll do whatever they can to drive a potential competitor out of town," charges Gene Kimmelman, executive director of the Consumer Federation of America, a consumer lobby group. "They want it both ways: They argue they want competition, yet they do everything imaginable to block it."

The cable industry vigorously defends its behavior, dismissing any notion that its practices are anti-competitive. Cable companies say they are simply protecting their markets, competing as any prudent business would. The big operators feel the threat of competition acutely, because they borrowed heavily to buy up cable systems in the 1990s. Cable companies further argue that it's virtually impossible for two cable operators in one market, offering discounted prices, to make a reasonable profit. In many respects, they argue, cable is a natural monopoly.

"What do you expect the operators to do—sit there like a bump on a log and lose customers?" asks Steve Wilkerson, president of the Florida Cable Television Association. "Cable operators are going to compete head to head to keep their customers. What is so anti-competitive about that?"

Keeping Their Distance

The big cable operators haven't tried to compete with one another; they buy and sell territories, but so far they haven't sought to penetrate one another's markets. Generally the challengers are frustrated small-town governments and scrappy companies, usually undercapitalized, that operate in areas where an incumbent has a reputation for giving poor service and increasing its rates.

More than 130 disenchanted communities are exploring the prospect of either inviting competition or starting a cable company of their own. One of them is Niceville, Fla., a hamlet (formerly known as Boggy) near the end of the state panhandle. Niceville has been fighting for the better part of a decade to start its own service. Warner Cable Communications Inc., a unit of Time Warner Inc., so riled the small town with rate rises and much-criticized service that angry residents voted to tax themselves to construct a $2 million cable system.

But Time Warmer used the courts to challenge the city's right to build, arguing among other things that by operating a system of its own, the government would be infringing on Time Warner's First Amendment right to free speech. After hard-fought victories, one in state court and another in the U.S. Supreme Court, the town proceeded this year to sell the bonds to start construction. But a bond-rating agency refused to rate the bonds, despite Niceville's respectable credit history. That's because Time Warner filed yet another lawsuit in 1987. This one charged the town with "unlawful municipal competition," alleging, among other things, that it misled residents about the cable system's viability.

Today, seven years and almost $300,000 after starting its effort, Niceville still hasn't strung its first inch of wire. "They [Time Warner] asserted every constitutional, legal and contractual theory I think I've ever seen," says Niceville city attorney Gillis Powell Sr." "It's been a very complicated, very costly, very exhausting experience."

James Moore, the attorney representing Warner Communications, argues that neither Niceville nor any other municipality belongs in the cable business. "How can the city be a regulator and a competitor at the same time?" he demands.

That is one of the questions the federal reregulation bill addresses. The bill would enable local governments to regulate rates for basic cable programming based on guidelines developed by the Federal Communications Commission, and would authorize the FCC to step in when local authorities don't do the job right.

The legislation is also aimed at encouraging competition to entrenched cable operators. It would prohibit exclusive franchises, requiring cities to consider at least two applicants. Local governments could operate a cable system without going through the formal franchising process. The bill would also require cable operator-owned networks that currently sign exclusive contracts, such as TNT, to sell programming to all comers.

The Allentown Example

There is evidence that on a level playing field, cable companies can compete, with attendant benefits for consumers. In Allentown, Pa., two private cable companies started 25 years ago at opposite ends of the town, met in the middle and continued to wire over one another's neighborhoods, house by house. The two—Service Electric and Twin County Trans Video—both are profitable today, and have split the market roughly in half.

"I'm not exaggerating when I say we have no problems whatsoever with cable," says Joseph Rosenfeld, as assistant to the mayor in Allentown. "These companies are terrified of people switching. I was watching an Eagles game that went out during an electric storm. Within half an hour, in the rain, they had the thing fixed."

Allentown is an exception mainly because it took a path that other communties didn't when cable television

began: It allowed two operators into its territory. As cable spread in the early 1980's, most local governments granted a single franchise to a single operator. Running two wires along poles or digging up public roads twice seemed impractical. In turn, cable operators often had to agree to costly concessions levied by city councils, which usually included a percentage of gross revenue, elaborate public-access studios and state-of-the-art equipment to televise council meetings.

Then, in 1984, cable companies argued that they needed relief from local governments' rate restrictions and unreasonable demands. Competition from emerging technologies would hold rates down, the industry argued. Besides, the broadcast networks had a far bigger audience than cable, which had wired less than half the country at the time.

So the Cable Act of 1984, which became effective in 1987, was intended to allow the industry to flourish, and at the same time open the door for competition. The industry has indeed flourished since deregulation—revenue has almost doubled in the past six years to $22 billion—but the emerging technologies still are larval, and incumbent cable operators doing battle with newcomers can exploit the considerable advantages of having had exclusive franchises.

By far the bloodiest cable battleground, even by the industry's sanguinary standards, is in central Florida, where Telesat Cablevision Inc. has gone up against some of the nation's most powerful cable operators. The fight has taken such a heavy toll that Telesat has canceled plans for any further expansion in Florida. Telesat's parent, FPL Group, owner of Florida Power & Light, has put Telesat up for sale.

Telesat, based in Pompano Beach, touched off a price war when it marched into central Florida in 1987. It started out wiring apartment buildings, then quickly expanded to more than a dozen communities serving 52,000

cable homes, in every market. Telesat met what its president, Harry Cushing, describes as the "scorched-earth policy" of entrenched cable companies.

In the Orlando area, Telesat encountered two of the industry's biggest operators; Cablevision Industries Corp., with 1.7 million subscribers nationwide, and Cablevision of Central Florida, a division of Time Warner Inc., with 6.7 million. (The two companies are unrelated: "cablevision" is a name widely used in the industry.) In 1987, the year Telesat made its debut in Orange County, Fla., Cablevision Industries charged $10.95 a month in its markets, and the Time Warner unit $12.95. Telesat came in at $9.95.

[Chart Omitted in Printing]

Both incumbents quickly cut their rates to $6.50—but left prices unchanged in neighborhoods that couldn't get Telesat. William Brown, president of Time Warner's unit there, calls the simultaneous rate drop "coincidence," adding, "there was absolutely no collusion."

Between the price wars and the race between companies to wire homes, Orange County quickly became a hodgepodge of different cable rates for different enclaves. Cindy Utter, who lives in one of Orlando's blue-collar subdivisions, pays the Time Warner unit $20.70 a month. But just down the road, in an area that gets Telesat, her neighbors pay Time Warner $13.95 monthly. "It's not fair," Ms. Utter fumes. Counters Time Warner's Mr. Brown: "It's fair to meet competition wherever it comes up. You have to protect your market share short of losing money."

Homeowners Get Involved

In 1990, at the behest of embittered residents, the local homeowners' association took the lead in pushing for an ordinance that would prevent cable companies from

charging different prices for cable in the same market. "We had a lot of people mad that they were subsidizing their neighbor's cable bill," says Cheryl Moore, then-president of the Orange County Homeowners Association.

Time Warner orchestrated the industry's counterattack, sparing no effort to make its presence felt by local politicians. On the day the Orange County Commission voted on the proposed ordinance, big cable trucks surrounded the building, and inside, virtually every seat was taken by Time Warner employees, who had been given time off with pay to attend the meeting.

They had arrived that morning shortly after 7 a.m., for the 9 a.m. showdown. "The residents were forced to stand up in the back, and there was no parking for blocks," Mrs. Moore says. "The people were livid." Time Warner's Mr. Brown says, "We gave employees time off and it was voluntary, but I'm pleased we had such a terrific turnout."

Heated debate ensued as the sides presented conflicting economic data. In the end, the ordinance failed, 3-2, with three Republican commissioners voting against it. The incumbents' presentation was made by two cable-company attorneys active in Republican fund raising. "Special interests hit a grand-slam home run and the residents lost," Linda Chapin, a commission member who spearheaded the argument for the new ordinance, said at the time. Weeks later, during a race for the job of commission chairman, Time Warner included campaign fliers for Ms. Chapin's (ultimately defeated) opponent in its monthly cable bill.

Level Playing Field?

Telesat now blames its lower-than-projected cash flow and choked-off subscriber growth in Orange County on the failure of the ordinance. The company's 42% penetration there contrasts sharply with the 61% it achieved in nearby Citrus County, which adopted a uniform-pricing

law. (A similar uniform-pricing provision is included in the regulation bill passed by the House and Senate.)

In Dade County, Telesat got stopped dead in its tracks by a state law known as the "level playing field" act. In theory, it was designed to ensure that the second cable franchise wouldn't get more favorable treatment than the incumbent. But in the 10 states where such legislation has been enacted, many cable newcomers contend it has enabled incumbents to manipulate the franchising process. Often at the established cable company's urging, local governments hold public hearings and conduct extensive studies on the impact of so-called overbuilders. In the end, communities frequently end up imposing more burdensome financial obligations and construction schedules on second cable systems. Dade County proved no exception.

For instance, a six-month, $100,000 study into the feasibility of competition led to one delay after another in the processing of Telesat's application for a franchise. At every county meeting, Mr. Cushing, Telesat's president, says the incumbents prodded the county to ask for more data before taking any action.

Finally, after 2½ years of waiting, Telesat withdrew its application. Among other reasons, it cited in its FCC filing "no hope of overcoming incumbent opposition with close political ties to commissioners." Later that year, the Dade County cable administrator who recommended doing a feasibility study was hired by Tele-Communications Inc., owner of Storer Communications Inc., one of the incumbent operators, to run its Miami cable operations. Anthony Bello, the former cable administrator, says any suggestion that the two events were related is "poppycock," stressing that Tele-Communications had no pending business with the county at the time of his job negotiations.

Elsewhere in Florida, even as Telesat toiled to lay wire, it found it couldn't get access to popular cable pro-

gram networks, many of which are at least partly owned by the largest cable operators in the country. For instance, Telesat can't get the Sunshine Sports Network, which carries Orlando Magic basketball games and Florida State University sports. The Sunshine network is 51% owned by a group of cable operators and 49% owned by a partnership between cable entrepreneur Bill Daniels and Liberty Media Corp., a spinoff of Tele-Communications. The network is distributed through exclusive contracts to incumbent systems.

Today, Telsat is struggling in virtually all its Florida markets. Several of its operations have been sold to or merged with incumbent operators, some of which charge Telesat with being a "green-mailer"—industry jargon for a company that enters a market for the purpose of inducing a buy-out. Mr. Cushing, Telesat's president, denies the charge. "I have a firm belief in the American dream," he says, "but I am disillusioned."

The few U.S. communities that have achieved cable competition have emerged as pockets of envy for the rest of America's couch potatoes.

In Paragould, Ark., the incumbent Cablevision Systems Corp. was determined to be the only game in town. When the town launched a $3.2 million bond issue to build its own cable system, Cablevision filed two lawsuits to stop it, and even offered to finance the new system on the condition Cablevision be allowed to operate it.

But the town system is up and running, and in the face of its first competition ever, once-vilified Cablevision Systems has become a paragon of service. If it doesn't repair outages within one hour, it will give $3 off or a free month of Home Box Office. And its rates are among the lowest in the country: Cablevision charges $9.50 a month for 45 channels; the town charges $12.50.

Paragould property owners have to pay an average tax of $3 a month to defray the cost of the town's new sys-

tem, but many think it's worth it. Amanda Gramling waited for years on the edge of town for cable service from incumbent Cablevision. But it wasn't until the town got into the business that both companies—Cablevision and the town system—beat a path to her door. "We're a lot better informed today, and we have one of the lowest rates around," says Mrs. Gramling, who now tunes into the town's live coverage of the county fair and her second-grade daughter's school plays. "We can thank competition for that."

COMMONWEALTH OF VIRGINIA

[State Logo]

STATE CORPORATION COMMISSION
December 21, 1992

Mr. Hugh R. Stallard
President
C&P Telephone Company of Virginia
Post Office Box 27241
Richmond, Virgina 23261

Dear Hugh:

Thank you for your December 17 letter and enclosures, including copy of the Complaint for Declaratory Judgment and Injunctive Relief filed by C & P of Virginia and Bell Atlantic Video Services Company in U. S. District Court for the Eastern District of Virginia (Alexandria Division) on December 17, 1992.

This material was delivered to the Commissioners by Mr. Warner Brundage. We appreciate the briefing that we received concerning this suit and also your offer to keep the Commission fully informed as the matter progresses.

We understand that no part of the litigation expenses will be assessed the ratepayers of Virginia and that the Company accounts will be maintained so as to ensure Virginia ratepayer protection.

This case will be a landmark one with far-reaching implications which, in my opinion, could determine the long-range development of the communications industry in America.

With very best wishes, I remain

Sincerely,

/s/ Preston C. Shannon
PRESTON C. SHANNON

PCS/ch

cc: Hon. Theodore V. Morrison, Jr.
Hon. Hullihen Williams Moore
Mr. Edward C. Addison

A Bell Atlantic Company
C&P Telephone
Legal Department

C&P Telephone Company of Virginia
600 East Main Street
10th Floor—Plaza
P.O. Box 27241
Richmond, Virginia 23261
804-772-1559

May 7, 1993

Jones Intercable Inc.
9697 E. Mineral Avenue
Englewood, Co. 80112

Attention: Sherry Gilmore
Legal Assistant

Dear Ms. Gilmore.

I understand that Jones is currently seeking a 20-25 year renewal of its franchise in the City of Alexandria, Virginia. As you know, the current Pole Attachment and Conduit Occupancy Agreement between C&P and Jones runs from year to year and is renewed each year automatically. This contract has been in place since 1979 and, frankly, I do not see or anticipate any reason for changing this arrangement. However, if you would be interested in a longer term contract to run concurrently with the time period of your renewed franchise, C&P would be willing to enter into such a contract.

If you are interested in negotiating a longer term contract, or have any questions, please call me.

Very truly yours,

/s/ James E. Howerton
JAMES E. HOWERTON
Claims Manager

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF VIRGINIA
(Alexandria Division)

[Caption Omitted in Printing]

AFFIDAVIT OF ROBIN SMITH

Robin Smith deposes and says:

1. I am the founder and current President and Chairman of the Board of Video/Action Fund, a public charity and independent production company that develops, documents, and promotes educational video programs. Prior to founding Video/Action Fund, I worked for more than fifteen years as a producer and filmmaker. From 1980 to 1986 I was a producer for two broadcast television networks: NBC, where I worked with the programs "1986" and "American Almanac," and CBS, where I worked with the programs "Sunday Morning With Charles Kuralt" and "The CBS Morning News." I have received a Master of Science in Public Communication from Boston University and a Bachelor of Fine Arts degree from Ohio University. My resume is attached as Appendix A.

2. Since its creation in 1990, Video/Action Fund has produced such programs as: "Who's Gonna Sing Our Song?"—a documentary on a multi-media project in which inner-city teenagers explored the history of their neighborhood through the arts; "Women of Substance"—an advocacy video on the barriers facing pregnant and parenting addicts when they seek treatment; and "Shooting Back: Photography By Homeless Children," which won a regional Emmy for outstanding documentary in 1991.

3. Video/Action Fund is one of a growing number of non-commercial production and media arts organizations through which artists, educators and independent producers are creating an enormous volume of culturally diverse programming. Appendix B to this affidavit provides a partial list of such organizations working on educational and public interest programming at the community level.

4. The primary outlets for programming created by independent producers working on shoe-string budgets outside of the commercial mainstream media are non-broadcast venues such as film festivals, school, library and museum programs, and community access cable. The number of people that are able to see this programming is limited by the size of auditoriums and screening rooms, as well as the ability of producers to make the community aware of the exact time the programs are being shown. We know there is a demand for what we produce because the audiences—limited as they currently are—are packed with under-represented people of all cultural, political and social identities eager to see or hear themselves on the screen.

5. Video/Action Fund—like all independent producers and media artists—seeks the broadest possible access to audiences and will utilize all distribution services available to us. Our productions have been shown on both broadcast and cable television. We also rely on mail order delivery of video cassettes. However, there are barriers in the current marketplace that inhibit the ability of non-commercial producers to disseminate all of our programming. Network show producers and cable broadcasters have a limited number of channels and are often looking for programming that fits a certain type or subject niche. Programming that doesn't "fit in" to existing schedules and formats is not considered for broadcast or distribution.

6. Independent producers and media artists are producing much more video programming than is currently being distributed on existing systems. As long as show producers and distributors stand as "gatekeepers" for the viewing audience, voices that do not conform to the video carriers' needs will not be heard.

7. For these reasons, independent producers like Video/Action Fund need and would welcome the development of new distribution channels and new program packagers for video and multimedia programming. Bell Atlantic Video Services' ability to package, market, and distribute video programming for access on demand presents new opportunities for independent producers and media artists to reach a much larger audience.

8. As telephone companies and others deploy new distribution alternatives, the existing "gatekeepers" will lose their power to limit the public's access to educational and community-oriented programming. Independent producers like Video/Action Fund will gain greater access to their audiences. A new genre of programming will emerge, utilizing the new interactive technologies in ways that are more responsive to the needs of individuals. Business relations and the interface between producers and distributors will improve. With more distribution outlets, small independent and non-profit producers will gain a precious commodity—a platform for diverse voices and visions that can be shared with the broadest possible audience.

9. Some parties defending this case have suggested that Bell Atlantic already has numerous opportunities to provide a forum for the voices of independent producers like the Video/Action Fund. They note that the video programming ban applies only to in-region programming carried over the telephone company's facilities and they cite the exemption for rural areas even within the company's service-area. They also claim that Bell Atlantic

can produce its own programming and either buy an existing over-the-air broadcaster or lease facilities from existing cable operators to show that programming.

10. Whether these statements are valid legally lies beyond the scope of my statement. However, the alternatives they suggest, even if true, simply would not solve the problems I have discussed above. The fact that Bell Atlantic may provide cable service in rural areas would not be helpful to many independent production entities which are located mostly in metropolitan areas and seek to give a voice to the concerns of people in those areas. Similarly, Bell Atlantic's ability to supply video programming of its own (such as NCTA's suggested "Bell Atlantic Hour"), will not help entities like the Video/Action Fund which need new outlets for their own shows. Production of additional programming, without also increasing the available channels of communication, would exacerbate, not ease, the problems which small producers face. And if BVS were to lease cable facilities, the number of distribution outlets left for community-based producers to lease would actually decrease.

11. The fact that Bell Atlantic might be able to purchase a cable system outside its region also would not increase the number of distribution outlets. The key value of Bell Atlantic's proposal to existing producers is that Bell Atlantic plans to use existing telephone facilities to provide new distribution outlets in competition with the existing cable provider. This will increase the number of channels available and hence increase the demand for programming from independent producers like Video/Action Fund. In other words, it is precisely because Bell Atlantic plans to provide video programming within its service area that its proposal is likely to increase the diversity of voices.

12. Nor would the FCC's recent action allowing telephone companies to provide a "video dialtone" service be of practical assistance to independent producers like

Video/Action Fund. Video dialtone in fact offers little if any improvement over the existing public access channels mandated by most cable operators' franchises. From the perspective of my organization and others similarly situated, mere provision of transmission facilities is not sufficient. Bell Atlantic would still be forbidden to perform the kinds of packaging, marketing and publicity functions that are crucial to the success of smaller producers. As I have already explained, having such services available to all providers can make the difference between a film that passes unnoticed and a professional production that serves to challenge people by adding to the diversity of opinion in the public forum.

I declare under penalty of perjury under the laws of the United States of America that the foregoing is true and correct. Executed on the 4th day of June, 1993.

/s/ Robin Smith
ROBIN SMITH
President
Video/Action Fund
3034 Q Street, N.W.
Washington, D.C. 20007

Appendix A: Resume of Robin Smith

* * * *

PRODUCTION CREDITS:

1993 "ART FOR EYES" (VIDEO/ACTION FUND) Executive Producer of a 30-minute documentary on the work of EYE CARE, an organization which collects and sells Haitian art in the United States to fund eye care clinics in Haiti.

1993 "WE ARE NOT WHO YOU THINK WE ARE" (VIDEO/ACTION FUND) Executive Producer of a 10-minute advocacy video in collaboration with THE WOMEN IN JAIL AND PRISON PROJECT OF THE CORRECTIONAL ASSOCIATION OF NEW YORK, examining the involvement of women in illegal drug activity from the point of view of women serving lengthy prison sentences for drug-related crimes.

1992 "WHO'S GONNA SING OUR SONG?" (VIDEO/ACTION FUND) Executive Producer of a 30-minute documentary profiling a multimedia history and humanities project developed by VIDEO/ACTION for sixty teenagers living in southeast Washington, D.C.

1992 "WOMEN OF SUBSTANCE" (VIDEO/ACTION FUND) Co-Producer of a 10-minute advocacy video exploring the problems encountered by addicted pregnant and parenting women seeking treatment for alcohol and drug abuse.

1992 "FOR REAL" (VIDEO/ACTION FUND) Executive Producer of five point-of-view videos addressing attitudes, lifestyles and perceived health care options of "at-risk" teenagers for use in a community Services Workstation—

a demonstration project funded by the Office of Disease Prevention and Health Promotion, Department of Health and Human Services.

1992 "ONE BLOCK AT A TIME" (VIDEO/ACTION FUND) Executive Producer of a 30-minute public service documentary on community-based efforts to combat substance abuse-related problems in the Washington metropolitan area; sponsored by Blue Cross/Blue Shield of the National Capitol Area and WRC-TV as part of a five year Drug-Free Zones Campaign.

1991 "YOUNG WOMEN'S RESIDENCE" (VIDEO/ACTION FUND) Executive Producer of a 10-minute video on a home for sexually and emotionally abused teenagers in St. Petersburg, Florida.

1991 "LOADED" (VIDEO/ACTION FUND) Executive Producer of a 30-second public service announcement on the dangers of drinking and driving.

1990 "SHOOTING BACK: PHOTOGRAPHY BY HOMELESS CHILDREN" (VIDEO/ACTION FUND) Executive Producer, Writer and Director of an award-winning 30-minute documentary on Jim Hubbard's work with homeless children which resulted in an exhibition of photographs showing life in the shelters through the eyes of children. (Broadcast nationally on PBS and The Learning Channel; recipient of Capitol Regional Emmy, National Academy of Television Arts and Sciences, and "Silver Apple," National Educational Film and Video Festival; selected to be screened at the International Monetary Fund

and the Council on Foundations Film Festival)

1990 "BEST BUDDIES!" (VIDEO/ACTION FUND) Executive Producer of a 10-minute profile of Anthony K. Shriver's national non-profit, volunteer program which introduces college students to people with mental retardation in an effort to promote friendship and an appreciation for community service.

1986-1991 NBC NEWS "SUNDAY TODAY" Field Producer of feature segments, including profiles of controversial photographer ROBERT MAPPLETHORPE, television personality MORTON DOWNEY, JR., and disabled Vietnam veteran, LEN NICHOLLS, who established a clinic for amputees in Hanoi.

1989 "TONY COELHO ON EPILEPSY" Producer and Director of a 10-minute video for THE COELHO FUND in which the former Congressman talks about his struggle with epilepsy.

1989 "SEEKING ANSWERS" Producer of a 20-minute informational video for THE NATIONAL LEAGUE OF FAMILIES OF AMERICAN PRISONERS AND MISSING IN SOUTHEAST ASIA.

1988 "THE BEST AMERICA" Producer and Director of a 30-minute special for the MICHAEL DUKAKIS PRESIDENTAL CAMPAIGN which was broadcast election eve simultaneously on all three networks.

1988 "HOMELESS IN AMERICA" Producer and Director of an award-winning video for TRIANGLE INDUSTRIES and THE MENTAL HEALTH ASSOCIATION which documents the

plight of homeless individuals and families across the country.

1987-1989 "USA Today on TV" Producer of cover stories including "SHOULD DRUGS BE LEGALIZED?," "FETAL ALCOHOL SYNDROME CHILDREN," "SHOULD MOTHERS OF CRACK BABIES BE PROSECUTED FOR CHILD ABUSE?" and "DISCRIMINATION AGAINST GAYS IN THE MILITARY."

1985-1986 NBC NEWS "1986" and "AMERICAN ALMANAC" Producer of numerous feature segments, including "A TICKET OUT," about a musical written and performed by inner city kids living in Chicago's Cabrini Green housing projects, and "LEAN ON ME," an award-winning feature on a special program in which victims of crimes and tragedies help others in similar straits.

1980-1985 CBS NEWS "SUNDAY MORNING" Producer of numerous features, including profiles of JOHN THOMPSON, Georgetown's controversial basketball coach; KATHERINE DUNHAM, founder of the first black dance company in America; and PHILLIPPE PETIT, high wire artist and street performer.

1979 "HE'S ONLY MISSING" Producer and Director of an award-winning half-hour documentary film on my father, a USMC aviator missing in action in North Vietnam.

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF VIRGINIA

[Caption Omitted in Printing]

AFFIDAVIT

DISTRICT OF COLUMBIA, S.S.

Bruce M. Owen, being duly sworn, deposes and says:

1. I am the president of Economists Incorporated, a Washington, DC economic consulting firm, and visiting professor of economics at Stanford University's Washington campus. I previously submitted an affidavit in this proceeding which summarizes my qualifications.

2. I have reviewed Plaintiffs' June 5, 1993 filings in this matter including the affidavit of their expert, Professor Kahn. Plaintiffs and their expert have mischaracterized my position as to why telephone company provision of video programming services in their telephone service areas raises serious competitive issues. I believe, for the reasons given in my earlier affidavit, that permitting telephone companies to provide video services in competition with other local sources of video programming will likely result in anticompetitive behavior in two related activities. Absent the ban on participating in video programming services, telephone companies will use their regulated telephone revenues to cross-subsidize and monopolize video transmission services. Telephone companies will then use their control of essential transmission facilities to deny access to and discriminate in favor of their pro-

gramming services affiliates, thereby allowing them to exclude competitors and earn above competitive profits for video services, as discussed in my earlier affidavit at ¶ 7.

3. Plaintiffs and their expert entirely miss the point regarding the relevant cross-subsidy issues raised in this matter and the crucial role played by § 533(b) in preventing anticompetitive abuses. Plaintiffs claim "§ 533(b) has nothing to do with preventing cross-subsidies, for the simple reason that telephone companies are *already permitted* to carry both telephone calls and video signals over their phone wires." Plaintiffs' Reply Memorandum at 33, emphasis in original. Similarly, Professor Kahn claims there is "no rational connection between the defendants' cross-subsidy argument and the ban against telephone companies providing video *programming*" because there could not be substantial costs common to the transmission of video programming and to the creation and packaging of video programming. Kahn Affidavit at ¶ 7, emphasis in original. Both arguments miss the mark because they ignore the central function of § 533(b) in curbing telephone companies' incentives to engage in cross-subsidization.

4. There are undeniably substantial common or joint costs involved in the provision of video transmission services and the provision of monopoly telephone services. Telephone companies are in a position to cross-subsidize video transmission service from monopoly revenues. What Plaintiffs and Professor Kahn ignore is that telephone companies' incentive to engage in that cross-subsidization is greatly enhanced if telephone companies are also allowed to exploit monopoly control of video transmission by earning excess profits in video programming. Simply put, the removal of § 533(b) would make a video transmission monopoly more valuable to a telephone company.

This makes it more likely that a telephone company will engage in anti-competitive cross-subsidization in order to obtain the video transmission monopoly. Because § 533(b) denies telephone companies the incentive and ability to discriminate against video programming competitors in order to earn excess profits in that activity, § 533(b) reduces the incentive to cross-subsidize video transmission in the first place. If a non-vertically-integrated telephone company discriminates against users of its video transmission service, raising their costs of doing business, it simply loses revenues from those customers. But if those customers' lost sales increase the market share and unregulated profits of the telephone company's programming affiliate, there is a net gain for the telephone company—it benefits from trading regulated, low-profit sales for unregulated, high-profit sales. The effect of being in the unregulated video programming business therefore is to increase the profitability to the telephone company of obtaining a monopoly of video transmission. Thus, § 533(b) protects competition in *both* video transmission and video programming and reduces the incentive for anti-competitive cross-subsidization, as I explained in my earlier affidavit at ¶¶ 15, 23 and 27.

5. Notwithstanding its irrelevance to him, Professor Kahn doubts whether telephone companies could cross-subsidize video transmission services from monopoly telephone services. Kahn Affidavit at ¶¶ 8-15. I disagree. Telephone companies retain monopoly power over many of their services; there certainly is no substitute for residential telephone service today, for example. Professor Kahn asserts that newer "incentive" regulatory arrangements have weakened the incentive or ability of telephone companies to cross-subsidize competitive services from monopoly services. As I pointed out at length in my original affidavit in this

proceeding (see ¶¶ 35-36), incentive or price-cap regulatory schemes cannot eliminate cross-subsidization because they do not sever the relationship between prices and costs for regulated services. In practice, telephone companies are likely to anticipate that cost-based rate reviews will occur at periodic internals; in the FCC jurisdiction it is every three years. Professor Kahn simply has ignored these arguments. As long as the relationship between costs and prices remains, shifting costs from competitive activities to monopoly activities will be profitable for telephone companies. Further, I am puzzled by Professor Kahn's assertion that, because telephone companies themselves allegedly have been the principal proponents of these newer incentive plans, the new plans therefore must offer protection against cross-subsidization. Kahn Affidavit at ¶ 13. This is a *non-sequitur*. It would be considerably less naive to draw exactly the opposite inference from telephone company support for these new regulatory schemes.

6. Professor Kahn also mistakes the potential cross-subsidization involved from misallocating the increased costs attributable to risk taking. Kahn Affidavit at ¶ 15. I did not claim, as Professor Kahn appears to believe, that companies with lower overall costs of capital should be excluded from competing against companies with higher overall costs of capital. The misallocation I was discussing involved passing the costs of engaging in risky competitive activities onto less risky monopoly services. Telephone companies providing only franchise monopoly services have low risks and appropriately enjoy low capital costs. Expanding their activities into competitive areas increases their risk and therefore their overall cost of capital. In a perfect world, regulators would not permit increases in the prices charged for monopoly services

because of the added risks and higher capital costs telephone companies take on when they expand into competitive activities. In practice, because a single firm provides both, the separate costs of capital for the two types of service are hidden from regulators, who can see only the capital costs of the firm as a whole. Thus, regulators see only the higher overall required rate of return that reflects the risky competitive activity. By allowing telephone companies to earn a higher rate of return in monopoly services reflecting their overall cost of capital, regulators in fact are permitting telephone companies to engage in cross-subsidization.

7. Professor Kahn also mischaracterizes the competitive concern involved in "self-dealing". Kahn Affidavit at ¶ 16. He claims there is a important distinction in that it is not the telephone company that here proposes to purchase programming from an affiliate, but rather the programming affiliate that would buy video transport service from the telephone company. But this distinction has no weight. Whichever way the telephone company decides to go, telephone company provision of video services presents a serious competitive problem. Under Professor Kahn's scenario, the programming affiliate will still be able to charge above-competitive prices because of the handicaps faced by its competitors who require access to the affiliated monopoly transmission service. Given that the telephone company will own the underlying video transmission monopoly and will be in a position to discriminate against its video affiliate's competitors, the video affiliate will have market power attributable to its competitors' artificially higher costs, which it will have every incentive to exercise. That is exactly analogous to the local Bell companies' former discrimination in favor of AT&T's former Long Lines Depart-

ment, that provided long distance telephone service in competition with alternative long distance carriers such as MCI. In the long distance market, competitors such as AT&T or MCI today purchase transmission services from local telephone companies, just as Professor Kahn would have the programming affiliate of C&P purchase local video transmission services from itself. Regulators were unable to remedy discrimination against long distance competitors of AT&T when AT&T owned the local companies. This practice led to the breakup of AT&T and the continuing restrictions on local Bell company provision of inter-LATA long distance service. That the long distance companies purchase local transmission service to reach their customers rather than the local companies purchasing long distance services makes a difference only in the details of the anticompetitive tactics, not in their likelihood or magnitude. To ban local telephone company provision of interexchange service was the only effective remedy. The same ban is needed against telephone company provision of video programming in order to prevent the same types of competitive abuses.

8. Professor Kahn concludes that there is no economic basis for the expectation that permitting the telephone companies to provide video programming directly to the public within their service areas would put them in a position to deny other video providers a fair opportunity to compete or, through cross-subsidization, to drive them from the market. For the reasons put forward in this and my earlier affidavit, I disagree.

/s/ Bruce M. Owen
BRUCE M. OWEN

[Notarization Omitted in Printing]

EXCERPTS FROM PRINCIPAL GOVERNMENT DOCUMENTS

As shown by the following excerpts, the government agencies responsible for telecommunications policy have concluded that the video programming ban in section 533(b) is unnecessary, anticompetitive, and should be lifted. The full text of the documents from which these passages have been extracted are included in the Plaintiffs' Document Appendix ("Pl. Doc. App.").

A. *Federal Communications Commission*

1. *Telephone Company-Cable Television Cross-Ownership Rules*, 7 FCC Rcd 5781 (1992) (Pl. Doc. App., Tab 1).

> —Based on a full administrative record, the FCC has recommended that Congress "permit the local telephone companies to provide video programming directly to subscribers in their telephone service areas, subject to appropriate safeguards. We find that such an amendment would . . . increas[e] competition in the video marketplace, spur[] the investment necessary to deploy an advanced infrastructure, and increas[e] the diversity of services made available to the public." *Id.* at 5847.
>
> —According to the FCC, "[t]he original justification for the cross-ownership ban in 1970 was to prevent local telephone companies from preemptively establishing a monopoly position in the provision of cable television service and other video services. The Commission was concerned that without the cross-ownership prohibition, local telephone companies would be the first to build cable systems in their communities and would be able to . . . establish themselves as sole providers of cable service and foreclose competition." *Id.* at 5848.

—"We conclude that the risks of anticompetitive conduct by the local telephone companies in connection with the direct provision of video programming have been attenuated by the enormous growth of the cable industry. . . . Rather than a fledgling industry unable to compete, the cable industry holds a leading position in the delivery and provision of video programming to the American public. . . . Given this widely changed competitive situation . . . there is little threat that the local telephone companies could preemptively eliminate competition and monopolize the market for video services." *Id.* at 5848-49.

—The FCC elaborated: "[W]e agree with those parties that argue that permitting local telephone companies to directly provide video programming will further increase diversity, as they will add another programming voice to those which now exist. . . . [W]e agree with DOJ that vertical integration should increase rather than reduce available programming. . . . Most importantly, we find that the public will benefit greatly from the resulting increased competition in the video marketplace . . . . [W]e conclude that the ability of local telephone companies to have significant ownership interests in video programmers, particularly independent and start up services, will further increase competition in the video market." *Id.* at 5849-50.

2. Letter from FCC Chairman James H. Quello to Hon. Edward J. Markey (Mar. 1, 1993) (Pl. Doc. App., Tab 3).

——According to Chairman Quello, "the majority in the Commission's video dialtone order found that telephone companies should be permitted to provide video programming directly to subscribers as a means of increasing competition in the video marketplace. The Commission has stated that the introduc-

tion of competition from local telephone companies in the video marketplace, subject to the safeguards . . . can be expected to bring consumers lower rates, more responsive customer service, and greater choice of video programming sources." *Id.* at Att. p. 3.

3. *In re Teleport Communications-New York*, 7 FCC Rcd 5986 (1992) (Pl. Doc. App., Tab 17).

—According to the FCC's order in this proceeding, "arguments that the telephone-company-cable cross-ownership restriction is no longer necessary are well taken. This Commission favors repeal of the statutory cross-ownership restriction, and we are recommending to Congress that the prohibition be repealed, and that traditional local exchange carriers be permitted to provide video programming in their telephone service areas pursuant to safeguards." *Id.* at 5988.

4. Report of the Federal Communications Commission Regarding the President's Regulatory Reform Program (Apr. 28, 1991) (Pl. Doc. App., Tab 2).

—According to the report: "Chairman Sikes has testified that the current statutory ban on telephone companies' providing competitive video services in their local service areas should be repealed, and instead the Commission should be authorized to permit local telephone company ownership and operation of cable television facilities." *Id.* at 30.

—The report also quantifies some of the expected benefits of competition: "Paving the way for telephone companies to provide the means for active rivalry in local multi-channel video markets would result in significant price savings for consumers and stimulate provision of a range of new information services. Current experience with head-to-head competition in cable markets indicates that rates would fall about 20% for the entire video package; if com-

petition is introduced nationwide, subscribership would likely expand by 11.2 million households. This implies annual consumer surplus gains (in Year 5 after the initiation of competition) of $5.36 billion, with net social benefits of approximately $750 million. This does not count the significant gains in innovative uses of broadband communications in non-entertainment markets such as health care, education, and telecommuting, all of which are very likely to follow from enhanced capacity and competitiveness in the supply of cable television services, nor does it include possible technological or macroeconomic stimulus from the $28 billion investment which is anticipated from competitive entry into video." *Id.* at 16.

5. *Telephone Company-Cable Television Cross-Ownership Rules*, 3 FCC Rcd 5849 (1988) (Pl. Doc. App., Tab 9).

—"The growth and financial success of the cable industry lessens the need for a prohibition on telephone company provision of cable television service and we do not believe a ban is now the correct option for achieving and preserving a competitive broadband marketplace. . . . Moreover, the ban also has an undesirable effect, in that it excludes a potential competitor to a mature cable industry. This is especially of concern if less draconian means are available by which to ensure against anticompetitive conduct by telephone companies." *Id.* at 5853.

—"We believe that the growth of the cable industry to the point where telephone companies can no longer preemptively eliminate cable competition and the fact that nonstructural safeguards are available, have rendered the cross-ownership ban presumptively unnecessary." *Id.* at 5854.

—"The ban is . . . a restriction on output which deprives society of services that otherwise could be provided by telephone companies. . . . [C]ompetition provided by telephone companies can be expected to provide the benefits we have generally associated with the provision of competition in the supply of communications facilities and services. These benefits include lower costs and greater choices for consumers and greater responsiveness to consumer demand by service providers." *Id.* at 5857.

—"[B]ecause allowing carriers to provide [video programming] subject to safeguards is more likely to achieve the Commission's objective of a fully competitive marketplace for broadband communications . . . we tentatively conclude that the costs of the cross-ownership ban exceed the benefits and that the public interest would be better served by . . . allowing telephone companies to provide cable television service subject to appropriate safeguards." *Id.* at 5858.

—"The evidence before us suggests that the prohibition against telephone companies providing cable television service within their telephone service areas no longer serves the public interest. . . . The ban directly deprives consumers of video programming services telephone companies could provide, prevents operation of market incentives and achievement of efficiencies that could bring additional services to the public, and nonstructural alternatives to the prohibition, including accounting safeguards, appear likely to control telephone companies' potential anticompetitive conduct without depriving consumers of telephone company services." *Id.* at 5866.

B. *Department of Justice*

1. Reply Comments of the United States Department of Justice, *Telephone Company-Cable Television Cross-*

Ownership Rules, CC Dkt 87-266 (Mar. 13, 1992) (Pl. Doc. App., Tab 6).

—The Department of Justice has concluded that telephone companies "should be allowed to own and directly provide video progamming," and that telephone company "provision of video programming will have procompetitive benefits that outweigh any anticompetitive risks involved." *Id.* at 44-45.

—According to the Department of Justice, removing the video programming ban "will allow another competitor to enter the video programming market . . . increase the [telephone companies'] willingness to take the financial risk of developing broadband integrated networks . . . make them more effective competitors, and will create an alternative player with whom third parties can bargain to carry their programming." *Id.*

2. Letter from Attorney General William P. Barr and Secretary of Commerce Barbara Hackman Franklin to Hon. Edward J. Markey (Apr. 1, 1992). (Pl. Doc. App., Tab 19).

——"It has been the Administration's consistent position that competition . . . creates the most substantial benefits for consumers and the greatest opportunities for American industry. Television viewers will be best served by removing barriers to entry by new firms into the video services marketplace. The Administration, therefore, supports removal of current legislative prohibitions against telephone company provision of video programming, with appropriate safeguards." *Id.* at 1.

3. Letter from Assistant Attorney General, Antitrust Division, James F. Rill and Secretary of Commerce Robert A. Mosbacher to Hon. John C. Danforth (Mar. 13, 1991) (Pl. Doc. App., Tab 20).

—"It has been the Administration's consistent position that competition . . . creates the most substantial benefits for consumers and the greatest opportunities for American industry. We think that Congress can best serve television viewers by removing barriers to entry by new firms into the video services marketplace. The Administration therefore supports removal of current legislative prohibitions against telephone company provision of video programming." *Id.* at 1.

C. *Department of Commerce*

1. Commerce Secretaries Robert Mosbacher and Barbara Franklin have each signed letters that "support[] removal of current legislative prohibitions against telephone company provision of video programming." *See supra* I.A.2-3.

2. National Telecommunications and Information Administration, *The NTIA Infrastructure Report, Telecommunications in the Age of Information* (Oct. 1991) (Pl. Doc. App., Tab 4).

—Based on this in-depth study, the NTIA, the branch of the Department of Commerce that is expert on telecommunications issues, concluded: "[T]he likely benefits of LEC [local exchange carrier] entry into the video programming business outweigh the potential costs of LEC provision of video programming, which are either overstated or can be effectively ameliorated by adapting existing regulatory safeguards to suit the video programming marketplace. Such entry would be one important means for expanding competition in the provision of video programming to the home. LEC provision of video programming would offer direct competition to incumbent cable systems. Moreover, requiring LECs to make channel capacity available on a common carrier basis would multiply opportunities for entry

by independent program providers, thereby stimulating competition still further." *Id.* at 235.

—"Repealing the cable-telephone company cross-ownership restriction could also promote development of the U.S. telecommunications infrastructure. The opportunity to provide programming should increase LECs' incentives to construct integrated broadband network facilities to carry that programming to the home. This, in turn, could lead to introduction of a wide range of innovative voice, data, and video services for subscribers." *Id.*

—"Allowing LECs to own, control, and provide video programming over their own facilities, subject to effective safeguards, could promote infrastructure development by increasing their incentives to deploy integrated broadband systems and other advanced networks. In general, government restrictions that have the effect of limiting the uses to which new technology can be put tend to be *inefficient and anti-competitive,* and retard investment in that new technology. In particular, we believe that the current cable/telco crossownership rules are having such an effect with respect to investment in broadband public network technology." *Id.* (emphasis added).

—"[A]llowing LECs to participate in the video services market . . . could provide some assurance that LEC broadband distribution facilities will be used, in an active and timely fashion, for the distribution of video entertainment programming. In such an investment environment, the LECs will clearly have greater incentives to deploy such [broadband] facilities. Moreover, once those facilities become established, they could well attract additional, unaffiliated program packagers, thus giving LECs further incentives to expand and upgrade their broadband networks. Finally, the availability of broadband facilities will likely spawn new applications—video and non-video alike—as entrepreneurs and

carriers devise new service offerings that will benefit the American public." *Id.* at 243.

—"LEC common carriage of unaffiliated programming, combined with LEC ability to provide programming, will promote, not hinder, diversity. . . . The nondiscriminatory common carrier model for LEC participation in the home video market will promote diversity by permitting both the LEC and unaffiliated video providers to deliver programming over LEC transmission facilities." *Id.* at 234.

3. Comments of NTIA, *Telephone Company-Cable Television Cross-Ownership Rules,* CC Dkt 87-266 (Feb. 3, 1992) (Pl. Doc. App., Tab 5).

—According to NTIA, "the full benefit of LEC participation in the video services market will be achieved only if the concept of "video dialtone" is extended to allow LECs to provide video programming in their local service areas. Accordingly, we urge the Commission to . . . recommend that Congress repeal the crossownership restriction in its entirety, subject to competitive safeguards, including the requirement that LECs make distribution facilities available to unaffiliated video programmers on a common carrier basis." *Id.* at 3.

—The NTIA elaborated that "although LEC provision of video distribution facilities on a common carrier basis should help promote competition, diversity, and infrastructure development, LECs may have only limited incentives to deploy such facilities unless they also have the ability to invest in, and offer their customers, video programming. . . . Government regulations should not preclude such investments (and the benefits that they produce) unless there are clear anticompetitive effects that cannot be addressed by less restrictive measures, such as regulatory safeguards. NTIA therefore urges the Com-

mission to move promptly to recommend that Congress repeal the telephone-company cable crossownership restriction in its entirety." *Id.* at 7-8.

4. Reply of the National Telecommunications and Information Administration, *In re Teleport Communications—New York*, File No. 13135-CF-TC(3)-92 (May 27, 1992) (Pl. Doc. App., Tab 8).

—"NTIA shares . . . concerns about the continuing wisdom of [the video programming] restriction, and we have repeatedly advocated its elimination. Allowing telephone companies to provide video programming in their local service areas would significantly increase competition in the video services market, which would, in turn, yield lower prices to viewers, better service quality, and better programming diversity. Further, allowing telephone companies to participate fully in the video services market should also stimulate development of the nation's telecommunications infrastructure, with concomitant benefits for all users, residential and business alike." *Id.* at 3.

5. Statement of Acting Assistant Secretary of Commerce for Communications and Information Thomas J. Sugrue Before the Senate Subcommittee on Communications on S.1200 (Feb. 28, 1992) (Pl. Doc. App., Tab 15).

—"[R]emoving a statutory barrier to broader telephone company provision of video programming, when coupled with safeguards to prevent anticompetitive behavior, . . . would increase competition in the video services marketplace. That should lead, in turn, to lower prices, better service, and a wider range of programming for consumers." *Id.* at 1.

—"I would like to reiterate the Administration's strong support for . . . the proposal to eliminate the existing telephone-cable cross-ownership restric-

tion. . . . [G]iving local exchange carriers ('LECs') freedom to participate in the video services marketplace should both expand competition in the provision of such services to the home and create incentives for LECs to construct advanced broadband facilities for the delivery of video to the home, which could promote development of our nation's telecommunications infrastructure. . . ." *Id.* at 5.

—"Despite the fact that technology increasingly would permit each of these two systems [telephone and cable] to offer a full range of services in direct competition with the other, despite the fact that this country has a strong commitment to competition over monopoly as the best economic structure to serve our people, we today prohibit, or severely restrict, competition between these two systems as a matter of public policy. The rationale for government imposed walls between these potential competitors is less convincing today than it once might have been. It is one thing to regulate when competition is not feasible; it is another to affirmatively regulate against competition when there are strong indications that competitive forces are straining against such regulations for a chance to emerge." *Id.* at 8-9.

EXCERPTS FROM PRINCIPAL GOVERNMENT DOCUMENTS[1]

A. *Federal Communications Commission*

1. *Telephone Company-Cable Television Cross-Ownership Rules*, 7 FCC Rcd 5781 (1992) (Pl. Doc. App., Tab 1).

> —The FCC's Order authorizing telephone companies to provide video dialtone states: "We conclude that existing safeguards against discrimination and cross-subsidization in the provision of basic services by the local telephone companies . . . should effectively protect against potential anticompetitive conduct by local telephone companies providing video dialtone." *Id.* at 5827.
>
> —"We further conclude that our existing safeguards with respect to nonregulated services are sufficient at this time to protect cross-subsidization. . . . [T]he Commission presently has in place a comprehensive system of cost allocation rules and cost accounting safeguards designed to separate non-regulated service costs from regulated service costs. In addition, we have recently strengthened these cost accounting safeguards in order to ensure that the Commission is able to prevent and detect abuses should they occur. To the extent that a local telephone company provides nonregulated services as part of video dialtone, these safeguards will apply fully. . . ." *Id.* at 5828-29 (citations omitted).
>
> —"As for the provision of enhanced services by local telephone companies, we note that in addition to the above accounting safeguards designed to prevent cross-subsidization between regulated and non-

[1] The full text of the documents from which these passages have been extracted are included in the Plaintiffs' Document Appendix ("Pl. Doc. App.").

regulated, the [telephone companies] are also subject to a comprehensive regulatory framework designed to protect against discrimination and other anti-competitive conduct. Among these safeguards is our ONA [Open Network Architecture] policy, which we have concluded constitutes an effective safeguard to ensure that independent [enhanced service providers] are able to obtain non-discriminatory access to basic [telephone company] services. We are not persuaded that there is any functional difference between the provision of enhanced services in the context of video dialtone and the provision of enhanced services generally." *Id.* at 5829-30 (citations omitted).

—In recommending repeal of the video programming ban, the FCC states: "We conclude that the risks of anticompetitive conduct by the local telephone companies in connection with the direct provision of video programming have been attenuated by the enormous growth of the cable industry. . . . Given this widely changed competitive situation, we find it reasonable to conclude that, with appropriate safeguards on their entry, there is little threat that the local telephone companies could preemptively eliminate competition and monopolize the market for video programming services." *Id.* at 5848-49.

2. *The Chesapeake and Potomac Telephone Company of Virginia*, W-P-C-6834, Order and Authorization (rel. Mar. 25, 1993) (Pl. Doc. App., Tab 61).

—The FCC's Order authorizing C&P to provide video dialtone service states: "[W]e believe that our existing safeguards, in conjunction with the requirement that C&P offer non-discriminatory access to the basic platform, are adequate to protect against anti-competitive conduct by C&P. Among these safeguards are the cost allocation rules and cost ac-

counting safeguards designed to separate nonregulated service costs from regulated service costs . . . our ONA policy, which we believe constitutes an effective safeguard to ensure that independent enhanced service providers are able to obtain nondiscriminatory access to basic services, and our nondiscrimination reporting requirements, and network disclosure rules. . . . We are not persuaded, nor has it been shown by commenters, that these safeguards are inadequate to protect against cross-subsidization and discrimination by C&P." *Id.* at 9-10.

3. Reply Memorandum of FCC, *United States v. Western Electric Co., Inc.*, C.A. No. 82-0192 (D.D.C. filed Jan. 18, 1991) (Pl. Doc. App., Tab 74).

—The FCC's brief urging removal of the information services restriction states: "The Department [of Justice] has concluded that, because of regulatory constraints, 'it is unlikely that any significant cross-subsidization would occur and go undetected even where [telephone company] information services share facilities and personnel with regulated telephone services. . . .' As the Department cogently points out, moreover, information services that involve primarily the content or the processing of information rather than transmission . . . would be likely to share fewer facilities and personnel with regulated telephone service. . . . The potential for an undetected misallocation of costs is reduced when there are fewer joint and common costs." *Id.* at 41 (citations omitted).

—"[T]he Commission's decision to implement 'price cap' regulation . . . will complement its regulatory safeguards by displacing the traditional ratemaking incentives to shift costs from nonregulated activities to monopoly services. . . . Under price cap regulation, the [telephone companies] no longer

are able . . . to recover in their rates for regulated services any increased costs they have allocated to those services. Under price cap regulation, any misallocation of costs to regulated services, even if undetected, generally would not enable a [telephone company] simply to raise its rates for such services to cover the misallocated costs and thus to recoup revenues to subsidize its nonregulated services." *Id.* at 43-44 (citations omitted).

4. Brief of FCC as Amicus Curiae, *United States v. Western Electric Co.*, No. 91-5263 (D.C. Cir. filed Aug. 31, 1992) (Pl. Doc. App., Tab 78).

—On appeal, the FCC reiterated that: "[R]egulatory safeguards are adequate to minimize the possibility of unfair competition by the [telephone companies] as they enter [information] services. More importantly in the context of this remanded proceeding, the Justice Department shares the Commission's belief and told the district court so. . . . The Commission relies in particular on its *Computer III* regime of nonstructural safeguards (most of which now have been implemented) . . . and its joint cost rules governing the allocation of costs among regulated and unregulated services (which have been implemented and affirmed on review). . . . The Commision believes that its regulatory policies make it unlikely that a [telephone company] could get away with abuses under current market conditions." *Id.* at 5-6 (citations omitted).

5. *Computer III Remand Proceedings: Bell Operating Company Safegaurds and Tier 1 Local Exchange Company Safeguards*, 6 FCC Rcd 7571 ("Pl. Doc. App., Tab 76).

—"[W]e have adopted and implemented a comprehensive regulatory framework that provides an effective alternative to structural separation for pro-

tection against anticompetitive conduct." *Id.* at 7576.

—"[W]e determine that our existing cost accounting safeguards and those proposed in the *Notice* constitute a realistic and reliable alternative to structural separation to protect against cross-subsidy. . . . [A]long with our safeguards against discrimination, [these] will permit realization of the public interest benefits of integrated provision . . . of basic and enhanced services without creating substantial risks of cross-subsidization in comparison to structural separation. We also determine that the adoption of price cap regulation for the LECs [local exchange carriers] constitutes an effective complement to cost allocation, reporting, and enforcement safeguards, to reduce . . . incentives to cross-subsidize." *Id.* at 7577-78.

6. Testimony and Summary of Statement of Alfred C. Sikes Before the House Subcommittee on Economic and Commercial Law (Mar. 18, 1992) (Pl. Doc. App., Tab 11).

—Then FCC Chairman Sikes testified: "Over the past five years, new regulatory approaches have also been instituted which go far toward reducing the possibility of discriminatory conduct or anticompetitive cross-subsidization. . . . Price caps reduce the likelihood of anticompetitive cost-shifting. . . . It should be noted, moreover, that some 36 State jurisdictions—including most of the largest States—have adopted their own system of incentives-based regulation." *Id.* at 9-10.

—"Whatever might have been possible prior to the break-up of the unified Bell System, or before we instituted a comprehensive package of regulatory safeguards, the reality today is that the FCC does have effective tools, and has clearly demonstrated

both the willingness and ability to use them." *Id.* at 10.

—The accompanying summary states: "[s]ince 1987, the FCC has instituted an array of new regulatory safeguards . . . which make anticompetitive cost-shifting infeasible."

7. Transcript of Hearings Before the Subcommittee on Communications on S.1200 (Feb. 28, 1992) (Pl. Doc. App., Tab 80).

—Chairman Sikes testified: "[W]e have . . . worked hard to facilitate competition to local exchange carriers, and at present they are competitively engaged in respect to many of the high-volume customers. Now, when you are facing competition, you simply cannot do that kind of cost shifting. For the most part, these competitive access providers probably have lower cost structures to begin with, and the thought that . . . local exchange carriers can kind of rightfully shift costs of new ventures in and still be competitive is just nonsense." *Id.* at 102.

8. *Telephone Company-Cable Television Cross-Ownership Rules*, 3 FCC Rcd 5849 (1988) (Pl. Doc. App., Tab 9).

—In this notice relied on by the government here, the FCC concluded that the "ban is presumptively unnecessary" because less restrictive "nonstructural safeguards are available." *Id.* at 5854. "[W]hile telephone companies continue to have the ability to . . . engage in anticompetitive cross subsidies, safeguards perhaps analogous to those devised in *Computer III* would avoid the costs to consumers caused by a ban and . . . even if such safeguards need to be supplemented by additional protective measures, those measures could be applied in an individual Section 214 proceeding." *Id.* at 5860.

B. *The Department of Justice*

1. Reply Comments of the United States Department of Justice, *Telephone Company-Cable Television Cross-Ownership Rules*, CC Dkt 87-266 (Mar. 13, 1992) (Pl. Doc. App., Tab 6).

> —The Department's brief urging repeal of the video programming ban states: "In connection with potential discriminatory conduct aimed at other information and video gateway service providers, the Department believes that video dialtone does not require safeguards other than the equal access requirement and other requirements that are generally applicable to enhanced services. Some information service providers will be able to reach consumers through cable company facilities as well as through LECs' video dialtone facilities. Thus, the LECs will be unable to discriminate against these providers in any meaningful way. With respect to other information service providers who will be dependent on the LECs' video dialtone facilities . . . as the Department stated to the MFJ court in supporting [Bell telephone company] entry into provision of information services, the existing safeguards combined with the overall difficulty of targeting discrimination against particular information service providers are likely to prevent serious anticompetitive abuses by the LECs." *Id.* at 18-19 (footnote omitted).
>
> —"The Department similarly does not believe that additional safeguards are needed to prevent LECs from cross-subsidizing competitive elements of video dialtone by misallocating the costs involved to their regulated local telephone services. Again, for the same reasons the Department stated to the MFJ court in supporting . . . entry into provision of information services, cross subsidization in this area is not likely to succeed in lessening competition, and price reduc-

tions are more likely to reflect greater competition than predation." *Id.* at 19.

—"Thus, the Department disagrees with those commentators who argue that the Computer III rules are inadequate to protect against anticompetitive conduct in connection with LEC provision of information services . . . and therefore, will be inadequate to protect against anticompetitive conduct in connection with the provision of video dialtone." *Id.* at 20 (footnote omitted).

—The Department urged repeal of the video programming ban because: "As discussed by the Department previously . . . the anticompetitive risks associated with [Bell telephone company] provision of information services are not sufficient to justify exclusion of these carriers from an entire line of business, given the economic risks of such behavior, structural elements of the network, and the *Computer III* safeguards developed by the Commission. These conclusions hold true for LEC provision of video programming as well." *Id.* at 46 (footnote citing Department briefs urging removal of the information services restriction omitted).

2. Memorandum of the United States in Support of Motions for Removal of the Information Services Restriction, *United States v. Western Electric Co., Inc.*, C.A. No. 82-0192 (D.D.C. filed Aug. 22, 1990) (Pl. Doc. App., Tab 73).

—"The information services restriction addressed a perceived risk that, if the [Bell telephone companies] were allowed to provide information services, they would use their control over the local exchanges to impede the development of competitive markets for these new services. The belief that this risk existed was based on a series of assumptions. First, it was assumed that all information service providers

would depend on access to . . . 'bottleneck' local exchange facilities. Second, it was assumed that . . . [telephone companies] would have the practical ability as well as the incentive to discriminate against their competitors . . . and to cross-subsidize competitive information service ventures. . . . Finally, it was assumed that regulation would not prevent such conduct and the . . . conduct would have anti-competitive effects. . . . These critical assumptions have proved flawed, however. Thus, there is no continuing justification for the information services restriction." *Id.* at 14-15.

—"Regulation . . . effectively constrains . . . discrimination against information service competitors. The [FCC] has developed and implemented detailed regulations to prevent discrimination . . . against competing providers of unregulated 'enhanced services,' *i.e.*, information services." *Id.* at 22.

—"There is no substantial risk that competition would be impaired by . . . cross-subsidization. . . . Because of regulatory constraints, it is unlikely that any significant cross-subsidization would occur and go undetected even where . . . information services share facilities and personnel with regulated telephone services. Since 1987, the FCC has implemented its *Joint Cost* rules and improved its auditing procedures. The *Joint Cost* rules . . . govern the allocation of costs between regulated and unregulated . . . activities." *Id.* at 33-34.

—"Moreover, information services that involve primarily the provision of content or the processing of information rather than transmission would be likely to share fewer facilities or personnel with . . . local exchange operations than the gateway services the Court already has authorized. . . . [T]he potential for misallocation of costs in violation of allocation regulations is minimal and even more easily de-

tected by regulators where there is a relative paucity of joint and common costs between exchange operations and ventures in the new market. Thus, allowing [telephone companies] to provide currently prohibited information services should not present any significant risk of cross-subsidization." *Id.* at 34-35.

3. Reply of the United States in Support of Motions for Removal of the Information Services Restriction, *United States v. Western Electric Co., Inc.*, C.A. No. 82-0192 (D.D.C. filed Jan. 18, 1991) (Pl. Doc. App. Tab 75).

—"Objectors' contentions that the [Bell telephone companies] are likely to impede information services competition are unfounded. Regulation . . . constrains the [telephone companies] from denying information service competitors access to exchange services and facilities used by [telephone company] information services and from unreasonably discriminating in the prices, terms and conditions on which such access is provided. In addition, the antitrust laws prohibit and provide sanctions for anticompetitive conduct. . . . Further, the [telephone companies] are unlikely to attempt to lessen competition through discrimination against information service rivals because the benefits to the [telephone companies] of discrimination would be uncertain at best and the costs likely would be substantial. Substitutes . . . constrain a [telephone company's] ability to raise information service prices by discriminating in the provision of its exchange services. . . . Moreover, if discrimination were overly broad and affected nonrivals, the [telephone company] would lose exchange revenues and profits. It would likely be very difficult, if not impossible, however, for a telephone company] to target discrimination precisely." *Id.* at 4-5.

—"Finally, there is no merit to objectors' contentions that the [telephone companies] would lessen information services competition by cross-subsidization, predation or strategic entry deterrence. Regulation by the Federal Communications Commission and the states constrains misallocation of information services costs to regulated exchange services." *Id.* at 6.

4. Brief of Appellee United States of America, *United States v. Western Electric Co.*, No. 91-5263 (D.C. Cir. filed Oct. 5, 1992) (Pl. Doc. App., Tab 79).

—The Department reiterated its views on appeal: "The United States also explained why it had concluded that there would not be a significant risk of anticompetitive conduct if the information services restriction were removed. Regulation provides one important constraint. By 1991 the FCC had implemented additional safeguards against discrimination and misallocation of costs that were not in effect in 1982 or 1987." *Id.* at 25.

—"In sum, the United States' analysis of the competitive risks of removing the decree restriction and allowing the [Bell telephone companies] to provide information services took into account the *combined* effects of regulation, the variety of telephonic and nontelephonic alternatives to many information services, and the practical difficulties of targeting discrimination. . . . The United States also explained that regulation would constrain misallocation of costs of . . . information services to regulated exchange services and that even if misallocations did occur they would not be likely to result in anticompetitive predation or increased information services prices." *Id.* at 28-29 (emphasis in original).

5. Statement of James F. Rill Before the House Subcommittee on Economic and Commercial Law at 16-17 (Mar. 18, 1992) (Pl. Doc. App., Tab 13).

—Then Assistant Attorney General Rill testified: "The prophylactic concept of information services restrictions has lost its relevance. . . . The concern that the [Bell telephone companies] could restrict access to their networks was removed by the combined effect of the FCC's new *Computer III/ONA* regulatory standards, and the obvious difficulty of effectively targeting discrimination without detection. . . . As the Department explained to the court in the information services remand proceedings, the costs of such discrimination . . . would be substantial, and the benefits uncertain. As there had been no evidence in the *AT&T* case of anticompetitive practices in information services by the old Bell System, there was no record of misconduct from which one could conclude that any particular anticompetitive behavior was likely to recur." *Id.* at 19-20.

—"In the Department's view, further safeguards . . . are unnecessary in information services. . . . There is no competitive justification for prohibiting the [Bell telephone companies] from providing particular types of information services. . . ." *Id.* at 20-21.

C. *Department of Commerce*

1. Comments of NTIA, *Telephone Company-Cable Television Cross-Ownership Rules*, CC Dkt. 87-266 (Feb. 3, 1992) (Pl. Doc. App., Tab 5).

—"Generally speaking, NTIA does not believe that LEC provision of programming will necessitate the adoption of novel safeguards to prevent anticompetitive conduct apart from the requirement that LECs offer distribution facilities to unaffiliated programmers on a common carrier basis. . . . [T]he Commission's existing accounting and cost allocation rules should be sufficient to control cross-

subsidization, and open network architecture requirements should prevent discriminatory conduct. . . . *Id.* at 8, n.21 (citation omitted).

2. Department of Commerce, *The NTIA Infrastructure Report, Telecommunications in the Age of Information* (Oct. 1991) (Pl. Doc. App., Tab 4).

—"[W]e believe that the concerns. . . . expressed about LEC participation in programming either may be overstated or can be addressed through FCC safeguards. . . . Well developed safeguards can address two of the 'traditional' concerns . . . regarding cross-subsidization and also discrimination, as evidenced by the history of pole attachment access and rates. The FCC's accounting and cost allocation rules can adequately control the danger of cross-subsidization of a LEC's programming activities by its regulated operations. As we stated in a recent filing with the FCC concerning so-called 'enhanced services,' those rules are extensive and effective in controlling cross subsidy. . . ." "The increased use of incentive regulation of LECs by the FCC and the states also decreases incentives to cross-subsidize." *Id.* at 233 & n.834.

—"Concerns about discrimination, as in the case of pole attachments, can be addressed in several ways regarding pole attachments specifically. . . . [T]here is an elaborate statutory and regulatory mechanism in place to address pole attachment disputes. . . . Moreover, this issue should be less serious than in the past, since nearly 90 percent of U.S. homes have access to cable television today." *Id.* at 233 (footnote omitted).

UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF VIRGINIA
Alexandria Division

[Caption Omitted in Printing]

June 17, 1993

HEARING ON MOTIONS

[1] (THEREUPON, the following was heard in open court.)

THE COURT: Good morning. You may call the case and take appearances first.

THE CLERK: Civil action 90-1751-A. Chesapeake and Potomac of Virginia, et al. versus United States of America, et al.

* * * * *

[18] [MR. TRIBE:] And the reason, that I begin this way is that I think the following context, when the ban was first promulgated in 1970 and codified in '84, it's quite plain that the telephone and cable television media were distinct. That is, phone companies could not transmit video programming over their own wires. So the only way they could do what the rule prohibits, the only way they could provide video programming directly to their subscribers would be to buy or build and then operate free standing cable systems.

So, quite naturally, the FCC and Congress thought of 533(b) through this structural paragon you described, namely as a fairly standard rule against cross ownership of two distinct media facilities albeit outside the broadcasting area—

* * * * *

[20] [MR. TRIBE:] In other words, it doesn't stop you from creating a television program. It also doesn't stop you from transmitting somebody else's programming, that of some cable operator.

THE COURT: But you may not do both.

MR. TRIBE: What they want to do is both. That's what they call vertical integration.

THE COURT: In your own area?

MR. TRIBE: Your own area and it's that function which is particularly interesting.

Now, although this is—that is in Loudoun County going on. And indeed this March, C & P obtained authority for a trial of a service that would provide video programming over existing copper wires without using fiber optic, something unthinkable not long ago.

Although it's going on as recently as last year, Congress heard testimony and it appears as tab five in the defendant's document appendix, that this sort of thing probably wouldn't be doable until the year 2001.

Now, accordingly, the 1992 Senate report that the NCTA cites at page 13 of the brief, still describes 533(b) as a cross ownership rule to enhance competition, page 47 of that report. And it did so after stating [21] that and I now quote from page 18, "telephone networks are incapable of carrying video signals to home."

That's what Congress thought in 1992. So still understandably how they look at this is say what this forbids is bind the cable company. But as soon as you focus on the technology, you see 533(b) in a different light, a light that focuses one's attention on the statutes testing unobscured from illusions of technological impossibility.

* * * * *

[42] [MS. WILSON:] This is not a situation where we have spectrum scarcities. That rationale does not apply. * * *

* * * * *

[45] THE COURT: Let's go the other way. The other way might be more interesting. Let's suppose it says telephone companies can't send television programming, but they can send McLehrer—McLehrer, whatever it is, Hour. Would that be—would that be constitutional?

MS. WILSON: No, it would not be constitutional, but that's my point. The government is not making those.

THE COURT: Well, let me go on. I understand. Let's suppose then it says—it says, you may not send the news programs and you may not send sitcoms. That wouldn't pass muster either, would it?

MS. WILSON: That's right.

THE COURT: And I guess you can see I can give you a list of what's on television in 1984.

MS. WILSON: The government cannot approve whether T.V.—telephone company wants to transmit McNeil Lehrer Hour or the Home Shopping Network. * * *

* * * * *

[46] THE COURT: I guess I'm not following you. Let's go back to my hypothetical that I gave you. You started off and you were clearly correct when you said, that the statute would not pass constitutional muster if it said phone companies could use video programming but not the news programs.

And then I said, well how about if it said [47] sitcoms and news programs and you said no, that wouldn't pass muster. And you also said that it's. But let's go on with my hypothetical. And I said, well let's keep adding to that list the description of everything that's on television as of 1984, the sitcoms. You go to all dramatic programs.

In other words, you can end up with a list that if you —if you got out the T.V. Guide for 1984 you could end up with a generic list of all the stuff that's on television.

And, why wouldn't that then also not pass muster? It wouldn't, would it?

MS. WILSON: If the government was to highlight all the particular programs—

THE COURT: To say look, you may not—they went through all the T.V. Guides for 1984. They listed generic, all the things T.V. broadcasters were doing and saying instead of vague video programming is what broadcasters do they say telephone companies may not do the following on—

MS. WILSON: That was purely content base. [*sic*]

THE COURT: So, what's the difference?

MS. WILSON: The difference is that—

THE COURT: One says, you have a generic list, two or three pages. The other one you have a short sentence that summarizes it in terms of what broadcast [48] test put on. I don't see the difference.

* * * * *

[50] THE COURT: Do you think Turner would have come out the same way if instead of a provision requiring cable television system operators to carry the video signals of certain commercial and noncommercial educational television broadcast stations if it prohibited rather than permitted? You think it would come out the same way?

MS. WILSON: I'm sorry. Could you repeat the question.

THE COURT: Suppose that—do you think Turner would come out the same way if instead of a requirement [51] that they carry that required cable television system operators to carry video signals of certain commercial and noncommercial educational broadcast station if it forbad it. Wouldn't it come out differently?

Isn't Turner in that sense fundamentally different from what we're talking about here?

* * * * *

[65] MR. GILLIGAN: They're also studies that have been submitted by the NCTA and Congress received testimony on this point that while there may be competition in the short term, that in the long-term, it would simply have the replacement of one monopoly for [66] another.

* * * * *

[75] [MR. SOKLER:] * * * In fact, it is allowed to speak through the Jones Intercable microphone or anybody else's microphone.

The problem Congress identified and the reason 553(b) [*sic*] is on the book is that Congress determined that if it allowed C & P to speak through its own microphone, the risk is far too great that at the end of the day, they would have the incentive and the ability to make sure that they would be the only microphone.

* * * * *

[91] THE COURT: Let met ask you what could the government have done to achieve the goal of diversity of view point and avoiding the economic concentration? What could they have done.

MR. TRIBE: Could have repeeled, 533(b) to add competition and done it subject to the kinds of regulations that the government itself says is adequate.

* * * * *

[107] [MR. TRIBE:] And, the fact is, that nothing, nothing in any act of Congress, at least any that I have looked at, not the 1984 Cable Act of which this is a provision, not the 1992 act, includes any finding at all about why 533(b) is supposedly needed or why less restrictive alternatives would be insufficiently effective.

THE COURT: So, your view is whether or not one gives deference and how much deference one gives is not necessary to reach in this case, because they never found it. They never came up with something specific enough to [108] deserve deference.

MR. TRIBE: Of course the law itself, I mean you can say we will attribute to Congress in every case, whatever findings it takes to meet the requirements of whatever level of scrutiny is applicable, but that would empty constitutional review of all significance.

* * * * *

[119] [MR. TRIBE:] The reason I say that is it's clear as I indicated at the outset when I first stood up that as recently as 1992, Congress thought that was technological impossibility. It thought this was across ownership ban, a ban on buying the other guy's microphone.

* * * * *

[130] [MR. GILLIGAN:] Again, the—I want to get to the sort of unstated premise here of the plaintiff's argument about congressional findings. They cite no authority for the proposition that Congress cannot legislate except by reference to specific findings that it issues.

THE COURT: No, they don't say that. They say that they can do anything they want to, but they're not going to get judicial deference unless they make it unmistakably clear that there are certain findings that support it.

* * * * *

[149] THE COURT: Well, the problem with calling it a cross ownership ban is that it isn't. It's just that simple. They can all cable companies. They're not forbidden from owing cable companies. What they are forbidden from doing is furnishing video programming. That's not a cross ownership restriction. It's a restriction on what you can do, on what you can speak.. So, I have—I understand your point, but you don't—

* * * * *

THE COURT: But, they don't ban them from being [150] in the video.

* * * * *

THE COURT: They're even permitted to own a cable company.

* * * * *

[151] THE COURT: So, I think—the only point I want to make with you about calling a cross ownership is that the judiciary does nothing if it doesn't look behind words like that the executive branch uses.

You can't call a duck a duck if it doesn't walk and quack and so forth and fly like a duck. It really doesn't—it isn't what I would term a classical cross ownership provision of which there are others.

* * * * *

[188] [THE COURT] This Court does defer to legislative judgments. But, it doesn't defer to speculation. It doesn't defer to post hoc rationalization. I'm more interested in what they said at the time they passed the act than what they said after the act.

* * * * *

IN THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

Record Nos. 93-2340, 93-2341

THE CHESAPEAKE AND POTOMAC COMPANY OF VIRGINIA, ET AL., PLAINTIFFS-APPELLEES

v.

UNITED STATES OF AMERICA, ET AL., DEFENDANTS-APPELLANTS

and

NATIONAL CABLE TELEVISION ASSOCIATION, INC., INTERVENOR-DEFENDANT-APPELLANT

On Appeal from the United States District Court for the Eastern District of Virginia

---

ORAL ARGUMENT
February 7, 1994

* * * * *

[15] THE COURT: I hate to interrupt you so early but aren't you regulating here what was being said by the very definition of video programming in the act. It defines video programming as programming culpable to what broadcast TV stations would do. So it seems to me that you are regulating what is said. As the District Judge said, you can get a look at the TV guide in 1984 and list everything in there and come up by that with a result.

* * * * *

[44] THE COURT: Are you saying Renton helps you or—

MR. FORREST: Absolutely.

THE COURT: But isn't that entirely different. I mean, there the same conveyor just moved out of the way and he had the same medium, dirty movies and dirty books, and presumably the same audience, and here you're forcing the telephone company to a different medium perhaps, to a different point?

* * * * *

ADMINISTRATION WHITE PAPER ON COMMUNICATIONS ACT REFORMS

* * * * *

VI. Cable-Telephone Crossownership

Although the existing cable-telephone company cross-ownership restriction of the 1984 Cable Act may have been appropriate when enacted, today it is an unnecessary and artificial barrier to competition in the delivery of video programming to American consumers and to investment in advanced local infrastructure. The Administration's proposal to remove the current restriction, coupled with its proposals to promote competition in local telephone service, will allow telephone companies and cable operators to compete in providing a full range of video, voice, and data services to the public. Such competition can promote investment that expands consumer choices and services.

To ensure that cable firms and telephone companies do not harm consumers or competition in providing these services, the Administration proposes *several safeguards* specified below, most notably requirements that most telephone companies and cable operators make transmission capacity available to unaffiliated video providers on a nondiscriminatory basis. In doing so, the Administration also seeks to protect diversity and competition in the flow of ideas, and to ensure that similarly situated firms are regulated similarly.

The Administration supports the general approach of H.R. 3636 to allow LECs to provide video programming in their telephone service areas, subject to certain conditions and safeguards. The Administration would propose somewhat different conditions and safeguards, which, however, are also designed to protect consumers and competition and prevent undue control of information content and conduit by any one firm.

Structural Separation:

- The Administration supports the approach in H.R. 3636 of requiring LECs to provide video programming through a separate affiliate, in order to prevent improper cross-subsidization and discrimination by the LEC.

- H.R. 3636 specifies many of the details of the separation requirements. The Administration proposes modifying this approach to charge the FCC with specifying the required degree of separation, subject to two basic requirements from H.R. 3636:

  —A LEC's video programming affiliate must have separate books, records, and accounts; and

  —Any contract or agreement between a LEC and its affiliate (1) must be pursuant to regulations adopted by the FCC, (2) must be on a fully compensatory and auditable basis, (3) must be without cost to the LEC's telephone service ratepayers, (4) must be filed with the FCC, and (5) must adhere with rules that will enable the FCC to assess the compliance of any transaction with its rules.

- The Administration supports the approach of H.R. 3636 in permitting the FCC to modify separation requirements for small and rural LECs at any time. H.R. 3636 would allow the FCC to modify separation requirements for other LECs beginning 5 years after enactment. The Administration proposes reducing that waiting period to 2 years, to provide greater regulatory flexibility in the face of changing conditions.

Nondiscriminatory Access Obligations:

- In order to promote competition and diversity in the flow of ideas, H.R. 3636 would require a LEC that provides video programming to subscribers in its service area to establish a "video platform," based on the

FCC's current "video dialtone" rules, and make it available to unaffiliated programmers on nondiscriminatory terms. The Administration supports this general approach, with some modifications.

- H.R. 3636, by its terms, would require that the rates for the platform be nondiscriminatory. The Administration proposes specifying that LEC provision of the video platform will be subject to all requirements of Title II of the Communications Act.
- H.R. 3636 appears to require a LEC to afford nondiscriminatory access to its video platforms only when it carries "affiliated" video programming (*i.e.*, programming in which the LEC has an ownership interest). The Administration proposes requiring a LEC to afford unaffiliated programmers nondiscriminatory access to its video platform whenever the LEC carries video programming.
- H.R. 3636 would require the FCC to limit the number of channels on a LEC's video platform that can be occupied by its video programming affiliate (that limit can be no lower than 25% of the platform's capacity). The Administration proposes to authorize the FCC to impose such a limit and give the FCC discretion in selecting what the limit should be.
- The Administration proposes to permit the FCC to modify any of the foregoing requirements for small and rural LECs. H.R. 3636 contains no similar provision for small, non-"rural" LECs.
- The Administration supports allowing the FCC to modify the definition of "video platform" beginning 1 year after enactment. H.R. 3636 contains no such provision.
- The Administration proposes to direct the FCC to adopt regulations, within 1 year of enactment, that would require cable operators to offer nondiscrimina-

tory access to channel capacity on their systems for unaffiliated programmers, except when technology, costs, and market conditions would make such offering inappropriate. H.R. 3636 requires that the FCC study whether to impose such obligations and report to Congress within 2 years after enactment.

Anti-Buyout Provisions:

- To protect competition in the provision of communications and information services and to further the flow of ideas, the Administration supports limiting a LEC's ability to enter the video services market via acquisition of cable systems operating in its telephone service area. The Administration proposes to limit cable companies' ability to acquire LECs providing local telephone service in the cable companies' franchise areas.
- The Administration supports the provisions of H.R. 3636 permitting in-region acquisitions occurring in rural areas and for joint LEC/cable operator use of the cable "drop wire." The Administration proposes eliminating the provision of H.R. 3636 that would permit a LEC/cable acquisition if the number of households served by the cable systems acquired constituted less than 10% of all households in the telephone service areas of the acquiring LEC and its affiliates.
- H.R. 3636 would also authorize the FCC to waive the anti-buyout policy at any time under certain conditions. The Administration proposes authorizing the FCC to change the policy by rule, or to grant waivers on a case-by-case basis, beginning 5 years after enactment, if it determines that such action would be in the public interest. Such acquisitions would, however, remain subject to the antitrust laws.

Franchise Obligations:

- The Administration supports the general approach in H.R. 3636 of removing some requirements of the Cable

Act for the LEC's video programming affiliate and any other user of the LEC's video platform, while maintaining others, such as must carry, retransmission consent, the provision of public, educational, and governmental channels, and others designed to protect consumers.

- To promote symmetric regulation of similarly-situated firms, the Administration proposes to authorize the FCC to remove some Cable Act requirements (most notably, the requirement to have a cable franchise) for cable systems that offer nondiscriminatory access substantially similar to that required by LECs by the bill, while maintaining the overall Cable Act regulatory structure. H.R. 3636 has no comparable provision.

Rural Exemption:

- H.R. 3636 states that provisions concerning the video programming affiliate, the video platform, provision of affiliated programming, and the ban on acquisitions do not apply to LECs offering video programming in rural areas. The Administration proposes to authorize the FCC to modify those provisions for such LECs.

* * * * *

FEDERAL COMMUNICATIONS COMMISSION

Washington

[FCC Logo]

OFFICE OF
THE CHAIRMAN

Statement of

Reed E. Hundt
Chairman
Federal Communications Commission

Before the

Subcommittee on Telecommunications and Finance
Committee on Energy and Commerce
United States House of Representatives

on

H.R. 3636, the "National Communications Competition and Information Infrastructure Act of 1993"

and

H.R. 3626, the "Antitrust Reform Act of 1993" and the "Communications Reform Act of 1993"

January 27, 1994

* * * * *

III. Competition In the Multichannel Video Distribution Market Entry

The market for multichannel video distribution is dominated today by cable television providers. This market should be opened to more competition. The existing prohibition that bars telephone companies from providing video programming to customers in their telephone service areas should be repealed. It is very appropriate, therefore, that H.R. 3636 would remove this restriction and allow telephone companies to compete with cable companies in providing one-way and interactive video services.

Direct, facilities-based competition between cable and telephone companies will produce substantial benefits for the American public. Competition in this market will spur the deployment of advanced technologies that are capable of delivering the full range of services that customers demand. These services include not only entertainment services, but also the growing number of educational, health, and social services that are accessible over broadband technologies.

In addition, competition in this market can be expected to produce the same positive results for consumers that we have seen in other markets for telecommunications services that have undergone the transformation from monopoly to competition: technological and service innovation, lower prices, and responsiveness to consumer tastes. Telephone company entry also will expand the electronic marketplace of ideas by creating new outlets for video service providers.

As you know, Mr. Chairman, the FCC already has taken steps to enhance competition in the multichannel video distribution market. Within a few months, U.S. consumers will be able to receive programming from a Direct Broadcast Satellite service. This service is capable of delivering scores of channels of programming directly to homes and offices equipped with 18-inch dishes.

In 1992, the Commission authorized telephone companies to offer video dialtone service within their operating territories through a basic "video platform" that provides non-discriminatory access to multiple video programmers. Since these rules were enacted, four telephone companies have received authorization from the Commission to construct and operate video dialtone systems for purposes of testing technology and evaluating consumer demand for the services offered.

Elimination of the existing cross-ownership restriction should stimulate new telephone company investment in facilities that are capable of delivering video and advanced telecommunications services. Consumers should be the beneficiaries of the expanded choices that facilities-based competition in this market will foster.

Safeguards

Adequate safeguards must be in place to ensure vigorous and effective competition between telephone companies and cable companies. In a report to Congress in 1992 that recommended removal of the prohibition against telephone company entry into video programming, the FCC cautioned that certain restrictions might be necessary to prevent potential anticompetitive practices, including possibly a requirement that a telephone company provide video programming to end users through a separate affiliate. H.R. 3636 would impose this restriction as an initial requirement and I support that approach.

The bill also would require a carrier to make available up to 75 percent of its capacity to unaffiliated video programmers upon request. I share the authors' concern that unaffiliated video programmers must have adequate access to the video platform to ensure delivery of their video programs and services. I also agree that the Commission should monitor closely the impact of this requirement during the first two years after enactment. Given the pace of change, it might be appropriate to give the

Commission the authority to modify the reserve requirement if an investigation shows that it is no longer in the public interest. Generally, the Commission should have the discretion needed to adjust its policies to achieve the overall goal of promoting competition. Similarly, while I support the bill's proposal to require the FCC to examine whether cable systems should be required to provide nondiscriminatory access to a video platform (just as telephone companies would be required to do), the FCC might be given the authority to adopt such a requirement, if its investigation shows that such enhanced access to cable systems would be in the public interest.

Mr. Chairman, I would like to offer one other suggestion before turning to H.R. 3626. The removal of barriers to entry into the local telephone market and the video distribution market as proposed by H.R. 3636 likely will accelerate the trend toward convergence of the markets for all telecommunications services. This trend suggests that, over time, traditional regulatory distinctions between telephone and cable companies will become increasingly blurred and outdated. It also suggests that serious consideration should be given to a third regulatory paradigm, one that would permit the FCC to regulate these emerging diversified service providers under a single, integrated system, rather than partially under Title II and partially under Title VI. As I will discuss later in my testimony, the Administration has suggested a possible third regulatory model to address the emergence of this new type of service provider.

In general, we should aspire not to impose unnecessary or duplicative regulations that increase consumer rates and hinder the development of fully competitive markets for telephony and video services. I hope this Subcommittee, therefore, will consider granting the Commission the regulatory flexibility necessary to permit it to refrain from imposing obligations that would undermine, rather than foster, the continued development of competitive markets for telephone and video services.

The Commission's exercise of its limited existing forbearance authority under Title II has produced substantial benefits—the permissive detariffing policy contributed to the development of a competitive long distance market and more recently to the emergence of competition for access services. Moreover, Congress last year recognized the importance of broad forbearance authority in facilitating the emergence of competitive telecommunications markets when it granted the Commission the discretion to forbear from imposing on commercial mobile service providers any Title II requirements except those contained in Sections 201 (non-discrimination), 202 (just and reasonable rates) and 208 (resort to complaint process).

* * * * *

[DoJ LOGO]

DEPARTMENT OF JUSTICE

STATEMENT OF

ANNE K. BINGAMAN
ASSISTANT ATTORNEY GENERAL
ANTITRUST DIVISION

BEFORE THE

SUBCOMMITTEE ON TELECOMMUNICATIONS
AND FINANCE
COMMITTEE ON ENERGY AND COMMERCE
U.S. HOUSE OF REPRESENTATIVES

CONCERNING

NATIONAL COMMUNICATIONS COMPETITION
AND INFORMATION INFRASTRUCTURE ACT
H.R. 3636

AND

THE ANTITRUST REFORM ACT
H.R. 3626

PRESENTED ON

JANUARY 27, 1994

* * * * *

The Administration also strongly endorses the provisions in H.R. 3636 that would permit existing cable and telephone companies to offer both video and telephonic services in the same geographic areas. The Administration also endorses the general thrust of the provisions in the legislation that prohibit telephone and cable television companies from acquiring each other within the same territory. It is crucial that public policy promote competition between methods for delivering telecommunications services.

* * * * *

TESTIMONY OF LARRY IRVING ASSISTANT SECRETARY FOR COMMUNICATIONS AND INFORMATION U.S. DEPARTMENT OF COMMERCE

ON

TELECOMMUNICATIONS REFORM LEGISLATION

BEFORE THE SUBCOMMITTEE ON ECONOMIC AND COMMERCIAL LAW
COMMITTEE ON THE JUDICIARY
HOUSE OF REPRESENTATIVES

JANUARY 26, 1994

* * * * *

CABLE TELEVISION-TELEPHONE COMPANY CROSS-OWNERSHIP

The Administration supports repeal of the current cable television-telephone company cross-ownership restriction in the 1984 Cable Act. We believe that telephone companies should be allowed to provide video services in their local exchange areas, subject to effective safeguards to protect consumers and competition.

* * * * *

TESTIMONY OF LARRY IRVING
ASSISTANT SECRETARY FOR
COMMUNICATIONS AND INFORMATION
U.S. DEPARTMENT OF COMMERCE

ON

TELECOMMUNICATIONS REFORM LEGISLATION

BEFORE THE SUBCOMMITTEE ON
TELECOMMUNICATIONS AND FINANCE
COMMITTEE ON ENERGY AND COMMERCE
HOUSE OF REPRESENTATIVES

JANUARY 27, 1994

* * * * *

The Administration supports repeal of the current cable television-telephone company cross-ownership restriction in the 1984 Cable Act. We believe that telephone companies should be allowed to provide video services in their local exchange areas, subject to effective safeguards to protect consumers and competition. The Administration is proposing two critical safeguards.

First, consistent with the approach of H.R. 3636, telephone companies will be required to make channel capacity available to unaffiliated video program providers on a nondiscriminatory basis, while providing video programming through separate affiliates. This requirement should create market opportunities for competing providers of video services, thereby reducing prices and expanding the diversity of programming and services available to telephone viewers.

Second, the Administration proposes to prohibit telephone companies from acquiring cable systems located in the companies' local exchange areas for at least five years. This will deter premature and potentially anticompetitive mergers between telephone companies and their most likely competitors, existing cable companies. The Administration proposal allows fewer exemptions of telephone company buyouts of cable firms than H.R. 3636. However, telephone companies operating in rural areas will be exempted, because these markets may be unable to support more than one carrier.

The need for this second safeguard may wane in the coming years as markets change, so the Administration has added to it a flexible element. We propose to authorize the FCC to begin proceedings that could allow such acquisitions five years after the date of legislative enactment, if certain conditions, to be established by the Commission, are met. An example of such a condition might be the presence of sufficient competition in the telephone company's service area in the delivery of telephone or cable services.

Of course, any telephone company/cable system acquisition would be subject to the antitrust laws in the same manner as an acquisition in any other industry.

The Administration's proposals on the "video platform" are similar to those in H.R. 3636, except that the Administration's proposal makes clear that the platform will be subject to all requirements of Title II, not simply the requirement that rates be nondiscriminatory, as H.R. 3636 appears to contemplate. The Administration proposal also requires a carrier to afford nondiscriminatory access to the video platform whenever it offers video programming.

* * * * *

SUPREME COURT OF THE UNITED STATES

No. 94-1893

UNITED STATES, FEDERAL COMMUNICATIONS COMMISSION
JANET RENO, ATTORNEY GENERAL, PETITIONERS

v.

CHESAPEAKE AND POTOMAC TELEPHONE COMPANY
OF VIRGINIA, ET AL.

ORDER ALLOWING CERTIORARI

Filed June 26, 1995

The petition herein for a writ of certiorari to the United States Court of Appeals for the Fourth Circuit is granted. This case is consolidated with No. 94-1900, *National Cable Television Association, Incorporated v. Bell Atlantic Corporation, et al.* and a total of one hour is allotted for oral argument.

June 26, 1995

SUPREME COURT OF THE UNITED STATES

No. 94-1900

NATIONAL CABLE TELEVISION ASSOCIATION, INCORPORATED, PETITIONER

v.

BELL ATLANTIC CORPORATION, ET AL.

ORDER ALLOWING CERTIORARI

Filed June 26, 1995

The petition herein for a writ of certiorari to the United States Court of Appeals for the Fourth Circuit is granted. This case is consolidated with No. 94-1893, *United States Federal Communications Commission and Janet Reno, Attorney General v. Chesapeake and Potomac Telephone Company of Virginia, et al.* and total of one hour is allotted for oral argument.

June 26, 1995

☆ U. S. GOVERNMENT PRINTING OFFICE: 1995 387147 20095